Financing Confederation

Today and tomorrow

Economic Council of Canada

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Contents

Members of the Economic Council of Canada ix

1 Introduction 1
The Objectives 1
The Setting 2
The Issues 3
The Division of Responsibilities among Governments 3
The Size of Government 4
The Setting of Economic and Social Policy Priorities 4
The Effective Provision and Financing of Public Services 4
The Stability of Government Revenues 4
The Conditionality or Unconditionality of Programs 4
The Equalization Program 5
Co-ordination, Stabilization, and Harmonization 5
Welfare Dependency and Equalization 5
The Intergovernmental Review 6
The Problem of a Fiscal Imbalance 6
Outline of the Report 9

2 The Equalization Program: Background, Objectives, and Performance 11
Origin of the Program 11
The 1957 Equalization Program 12
Major Changes in the Program since 1957 13
Attempts to Limit Total Equalization Payments 14
The Ontario "Rider" 15
The Financial Consequences of Changes in the Equalization Program 15
The Calculation of Equalization Payments 16
Evaluation of the Equalization Program 17
Evaluation under the "Gross" Approach 18
Evaluation under the "Net" Approach 19
Summary and Conclusions 22

3 The Principles of Equalization 25
Is an Equalization Program Really Necessary? 26
The Equity Case for Equalization 27
The Broad- and Narrow-Based Views of Equity 28
The Major Sources of Differences in Net Fiscal Benefits 29

Other Factors Related to the Size and Interprovincial Distribution of Net Fiscal Benefits 31
Efficiency Arguments for Equalization 32
The Extent of Fiscally Induced Migration in Practice 33
Summary Observations on Equity and Efficiency 33
An Evaluation of Alternate Approaches to Equalization 33
Replacement of the Equalization Program with a Negative Income Tax Program 33
Recognition, through Equalization, of Interprovincial Differences in the Need, or Cost, of Public Services 33
Equalization and the Differential Treatment of Renewable and Non-Renewable Resources 34
The Adoption of a General Macro-economic Indicator for Determining Equalization Transfers 34
The Parliamentary Task Force Proposal 34
Direct Equalization among Provincial Governments 35
Conclusions 35

4 The Value of Natural Resources in Canada 37
The Concept of Economic Rent 37
The Estimation of Natural Resource Rents 38
Economic Rent from Oil and Natural Gas Production 39
Economic Rent from Hydro-Electricity Production 39
The Interprovincial Redistribution of Economic Rent 40
Crude Oil Rents Not Collected by Provincial Governments 40
Natural Gas and Liquefied Petroleum Gas Rents Not Collected by Provincial Governments 41
Hydro-Electricity Rents Not Collected by Provincial Governments 41
Equalization of Natural Resource Revenues 41
The Provincial Distribution of Economic Rent in Canada 42
Conclusions 44

5 From Principles to Practice: Reforming Equalization 45
Simulations of Changes in the Equalization Program 46
The Impact on Entitlements of Various Approaches to Equalizing Natural Resource Revenues 46
The Exclusion of Hydro Rents 47
The Inclusion of Hydro Rents 47
Projections of Equalization Payments 48
Conclusions 51

6 Established Programs Financing and Social Policy 53
The Fundamental Issue: Jurisdiction 54
The Immediate Issue: Provincial Spending 56
Trends in Provincial Health Expenditures 56
Trends in Provincial Postsecondary Education Expenditures 57
The Impact of EPF 58
An Issue of Fairness: The Intergovernmental Fiscal Balance 58
The Federal Burden 59
The Position of the "Have-Not" Provinces 60
Conclusions 62

7 Canadian Health Care Expenditures and Health Care Services 63
International Comparisons 63
Canadian Historical Experience 65
The Development of Health Insurance Programs 68
Provincial Variations in Health Services 70
Hospital Operating Expenditures 70
Patient-Days per Capita 71
Costs per Patient-Day 72
Mental Hospitals and Other Institutions 73
Expenditures on Physicians' Services 75
Levels of Service 77
Conclusions 79

8 The Fiscal Arrangements Act and the Conduct of Economic Stabilization Policy in the 1980s 81
The Case for Stabilization Policy 81
The Rationale for Federal-Provincial Co-operation in Stabilization Policy 82
The Scope and Limits of Federal-Provincial Co-operation in Stabilization Policy 83
Federal-Provincial Fiscal Arrangements and Stabilization Policy 83
Conclusions 85

9 Tax Collection Agreements and the Objectives of Tax and Fiscal Harmonization 87
The Issues 87
The Tax Collection Agreements 88
Personal Income Tax Provisions 89
Corporate Income Tax Provisions 89
The Development of Tax Harmonization 90
Provincial Autonomy and Economic Efficiency 92
Recent Provincial Initiatives and Tax Competition 94
The Revenue Guarantee 94
The Administration of Provincial Tax Credits 95
The Promotion of Provincial Economic Development 95
Foreign Tax Provisions 98
Crown Corporations 98
Conclusions 100

10 The Politics and Process of Fiscal Arrangements 103
The Quinquennial Review of the Fiscal Arrangements 103
The Development of Intergovernmental Relations 103
The Formal Nature of the Quinquennial Review 105
The Process of the Quinquennial Review 105
The Review of the Fiscal Arrangements: An Evaluation 107
Executive Federalism: Democracy and Efficiency 108
Federalism and Interdependence 112
Conclusions 115

11 The Issues: Conclusions and Recommendations 117
The Need for Change in the Fiscal Arrangements Act 117
Fiscal Imbalance and Proposals for Reductions in Federal-Provincial Transfers 117
The Equalization Program 119
The Search for Principles Governing Equalization 119
The Financing of the Equalization Program 121
The Determination of Equalization Payments 121
Established Programs Financing 123
Current Issues and Options 124
The Tax Collection Agreements and the Objectives of Tax and Fiscal Harmonization 128
Discriminatory Taxation Measures 128
Tax Competition among Provinces 129
Fiscal Arrangements and Stabilization Policy 129
The Politics and Process of Fiscal Arrangements 130
Democracy and Effectiveness in Decision Making 131
Federalism and the Quinquennial Review of the Fiscal Arrangements 131
Reform of the Process 131

Dissent and Comment by Pierre Lortie 133

Appendixes

A Some Empirical Evidence on the Interrelationship of Equalization, Fiscal Structure, and Internal Migration 137

B The Calculation of Natural Resource Rents and Their Distribution 145

C Specific-Purpose Grants for Health Insurance and Post-secondary Education: From Cost Sharing to Block Funding 157

D Statistical Data Pertaining to Chapter 7 161

Notes 171

List of Tables and Charts 179

Project Staff 183

This report reflects a consensus of the Economic Council of Canada; however, a dissent and comment by Mr. Lortie appear after Chapter 11.

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READER'S NOTE

The reader should note that various conventional symbols similar to those used by Statistics Canada have been used in the tables:

- -- amount too small to be expressed
- .. figures not available
- ... figures not appropriate or not applicable
- - nil or zero
- e estimated figures.

Details may not add up to totals because of rounding.

Introduction

The Objectives

Every five years, the federal and provincial governments undertake a review of the federal-provincial fiscal arrangements. This quinquennial review has taken place ever since the practice became established some 40 years ago when intergovernmental agreement was reached on one of the forerunners of the present arrangements, the Wartime Tax Agreements.

Currently, the federal and provincial governments are again in the midst of such a review. While numerous and varied financial links exist between the federal and provincial governments, at issue is primarily a federal statute entitled "The Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977" (hereafter referred to as the Fiscal Arrangements Act). The key elements of this legislation are the provisions relating to the Tax Collection Agreements, the Equalization Program, and Established Programs Financing (EPF). Normally the review would be completed prior to March 31, 1982, when the terms of the Equalization Program expire. New legislation would then be passed by Parliament covering these programs for another five-year period.

This review of the fiscal arrangements and, of course, the arrangements themselves are of paramount importance to all Canadians. The very magnitude of the resources involved in the programs underlines their significance. In 1980/81, the federal government transferred $13 billion in cash to the provincial governments in keeping with the provisions of a variety of programs, which in total account for about 20 per cent of total federal expenditures. These cash transfers constitute as much as 50 per cent of the total revenues in the Atlantic provinces (see Table 1-1). Of this total, some $10 billion will be paid out under programs covered by the Fiscal Arrangements Act. In addition, the tax transfers that the provinces have accumulated over the years in partial payment for joint federal-provincial programs will have a value of approximately $5 billion in 1981/82.

Quite apart from the magnitude of the funds involved, the fiscal arrangements reflect very significant characteristics of the economic and political

Table 1-1

Federal Transfers[1] to Provincial Governments as a Proportion of Total Gross General Revenue, Canada, Selected Years, 1957-80

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia
						(Per cent)				
1957	52.7	55.6	46.6	45.7	13.0	17.6	47.1	28.4	21.7	28.2
1962	59.9	51.7	44.2	46.3	27.7	22.1	30.5	25.6	22.0	18.6
1967	61.7	57.1	54.6	48.5	23.7	18.1	34.0	25.7	20.3	15.5
1972	52.3	50.1	42.0	43.4	21.4	19.3	32.3	37.2	20.3	15.7
1977	47.1	54.8	46.6	47.4	23.5	17.6	34.9	18.2	9.7	16.4
1980	47.7	52.8	45.8	43.9	21.6	17.3	37.6	16.9	7.7	16.1

1 Excluding tax transfers.
Source Based on data from Statistics Canada.

environment in Canada. Some of these characteristics include:

- the major scale of operations by the federal and provincial governments relative to the economy as a whole;
- the autonomous and independent roles played by the federal and provincial governments in the determination of an extensive and complex range of social and economic programs; and
- the extraordinary degree of interdependence among governments, with joint policy making and shared responsibilities being an integral aspect of many of these programs.

Despite the significance of the fiscal arrangements, this topic remains complex and not well understood. One important objective of the Economic Council in publishing this report is to help Canadians to become better informed about the nature of the programs covered by these intergovernmental arrangements and to be more aware of the important part they play in their daily lives.

In analysing the fiscal arrangements, the report focuses on the three major programs under the Act – the Tax Collection Agreements, the Equalization Program, and Established Programs Financing. It does not analyse in detail other important federal-provincial fiscal programs that do not come under the Act – for example, the Canada Assistance Plan, programs under the federal Department of Regional Economic Expansion, and those relating to manpower training, to name but a few. It should be noted, however, that fiscal programs beyond the scope of the Act – notably the Canada Assistance Plan – have been important in past reviews of fiscal arrangements.

The focus of this report has been confined to the programs under the Fiscal Arrangements Act for a number of reasons. These programs account for 75 per cent of all federal-provincial transfers. They are also the ones that are currently under review by the federal and provincial governments in their negotiations concerning fiscal arrangements.

This report is restricted to issues pertaining to federal-provincial fiscal arrangements and ignores those involved in local government financing and in relations between local governments and other levels of government. Many of the same issues that arise in federal-provincial fiscal matters also arise in arrangements between provincial and local governments. We are not asserting that the latter issues are unimportant; they are simply outside the focus of the present report.

In addition to its informational function, the report is also intended to provide a useful input for those in government who are involved in the policy-making process. While extensive revisions were made in the programs under consideration in 1977, it is our underlying conviction that changing circumstances and practical experience dictate the need for further substantial reshaping of the policies governing these programs. It would seem premature, however, to incorporate many of these major changes in the upcoming revision of the legislation because the issues that need to be resolved are complex, and major gaps exist in the relevant information and analysis.

In our view, policy makers should press forward as quickly as possible with studies and discussions as a prelude to major changes in the system, at least before the next set of federal-provincial negotiations in 1987. The adoption of proposals designed to implement major change requires a wide degree of public and government support, which can only be achieved through extensive and thorough public examination and debate. High priority should be given by those responsible for the formulation of policy to examination of the long-term issues related to fiscal arrangements.

In brief, the main goals of this report are:

- to examine and determine the appropriateness, under current and prospective circumstances, of the tax and transfer arrangements between the governments of Canada, the major programs being the Equalization Program, Established Programs Financing, and the Tax Collection Agreements;
- to consider some long-term, fundamental adjustments to the arrangements, along with some modifications for immediate implementation;
- to promote an understanding of these arrangements and issues by Canadians generally.

The Setting

The background behind the development of these programs is a complex history of the various precursors of the programs now grouped under the Fiscal Arrangements Act. While the specific historical details are outlined more fully later on in the report, a brief portrayal of the development of these arrangements will provide a setting and help the reader to gain initially some understanding of their nature.

From very early on in Canada's history, the need emerged for co-operation and consultation on fiscal matters between the federal and provincial governments. A crucial aspect in reaching agreement on Confederation was the federal government's commitment to make financial subsidies to the provinces.

They were designed to replace the taxing powers lost by the provinces under the division of powers in the British North America Act (BNA Act). Moreover, these subsidies were the subject of considerable debate and adjustment during the first years of the new nation.

While these early instances of intergovernmental liaison on fiscal matters were important, the major elements of the present system of fiscal arrangements evolved with the growth in government activities. Beginning with the Depression of the 1930s, there was increasing government intervention in economic and social affairs. These new economic and social responsibilities reflected a greater commitment to "full" employment, economic growth, trade liberalization, regional development, and infrastructure investment. Inevitably, the assumption of these responsibilities led to a growing need for intergovernmental liaison and joint policy making on fiscal matters.

A major factor in the development of the fiscal arrangements was the *Report of the Royal Commission on Dominion-Provincial Relations* [the Rowell-Sirois Commission][1] in 1940. In response to the new responsibilities of governments and the economic dilemma of the 1930s, the Commission recommended that the federal government take over the debts of all the provinces and the responsibility for unemployment relief. In addition, it advocated that the federal government pay a "National Adjustment Grant" to the less fortunate provinces in order to give them the opportunity to bring standards of services in those provinces up to the national average. In return, the Commission recommended that the provinces give up their claim to several taxes, including personal income tax, direct taxes on corporations, and succession duties.

Despite the fact that the report of the Commission was rejected by three provinces, the exigencies of the Second World War enabled the federal government to persuade the provinces to surrender their right under the Constitution to levy personal and corporate income taxes in return for per capita cash transfers from the federal government, which became known as "tax rentals." Ever since then, the federal government has collected personal and corporate taxes in most provinces. For the past several years they have been collected on behalf of the provinces themselves. Also, for many years there have been agreements aimed at the harmonization of federal-provincial taxation.

The recommendations in the Rowell-Sirois report for a national adjustment grant took longer to implement. Even the tax rental agreements in effect during and after the war embodied, to some extent, the rationale behind the Rowell-Sirois proposal, however; and with the adoption of the Equalization Program in 1957 the concept of equalization advocated in the Commission's report was formally established.

The other important elements now under the fiscal arrangements – the Established Programs Financing arrangements involving health and postsecondary education – were primarily developed as part of the social system between the late 1950s and the early 1970s. Prior to 1977, programs that now come under Established Programs Financing were financed through a sharing of costs by the federal and provincial governments. This type of shared-cost grant has a long history, especially in the areas of transportation, agriculture, and pensions. It was in the postwar period, however, that the federal government took steps to establish the majority of shared-cost programs in the areas of hospitalization, medical care, and postsecondary education, despite questions concerning its jurisdiction in these areas. In 1977, these shared-cost programs in health and postsecondary education were converted into a form of block grant and grouped together under Established Programs Financing. In contrast to other shared-cost programs, health care and postsecondary education were designated as mature or "established" programs that, as such, required few federal conditions to govern their operations by the provinces.

The Issues

The Council has found many attractive features about the present fiscal arrangements. In general, there are more aspects of the arrangements worth preserving than modifying. Still, a number of issues have recently been raised that bring into question fundamental elements of the existing arrangements. In this section, we shall describe these issues, as lawyers say, "without prejudice," in order to establish at the outset the parameters of the debate on the fiscal arrangements. In the body of the report, we shall evaluate many of the issues and identify those which deserve attention.

The Division of Responsibilities among Governments

The debate on this issue relates to the interdependent character of the fiscal arrangements identified earlier. Some see the sharing of responsibilities in the programs that form part of the fiscal arrangements as a positive attribute. From this viewpoint, it is argued that federal and provincial interests need to be further integrated to improve joint policy making in the fiscal arrangements. At the same time, others allege that there is a fundamental flaw in such interdependence

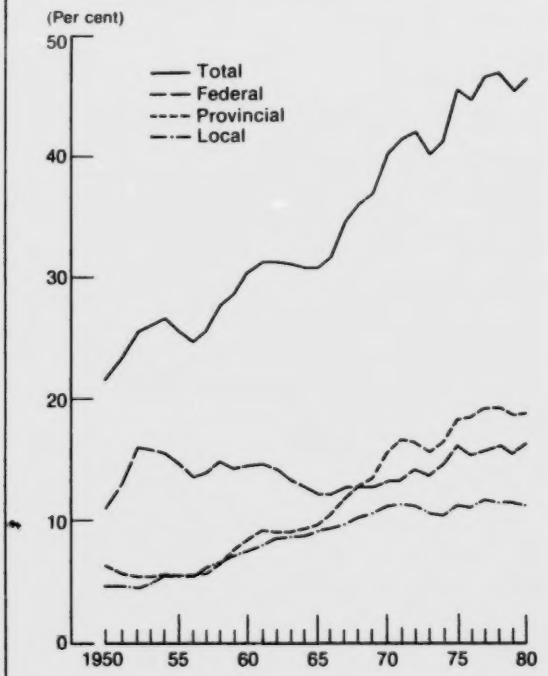
because the public cannot easily identify the responsibilities of each government; thus those who are supportive of this view advocate substantial "disentanglement" of federal-provincial responsibilities and programs. The main principle behind disentanglement is often suggested to be that each government should match its own revenue-raising capacities with its expenditures.

The Size of Government

Governments at all levels carry out an extensive and complex set of activities in our society. For the past five years, total federal, provincial, and local government expenditures have amounted to approximately 40 per cent of gross national product (see Chart 1-1). To some, the very magnitude of government activities acts as a deterrent to the efficient operation of the Canadian economy. An effort to reduce the overall size of government, in line with this view, could adversely affect the social and economic programs established as part of the fiscal arrangements. The option open to those who support this approach is either to reduce or to terminate some of the programs.

Chart 1-1

Federal, Provincial, and Local Government Expenditures[1] as a Proportion of Gross National Product, 1950-80



1 After cash transfers among all governments.
SOURCE Statistics Canada, *National Income and Expenditure Accounts*, Cat. 13-201, various issues.

The Setting of Economic and Social Policy Priorities

An important, on-going issue with respect to the fiscal arrangements is that of which level of government – federal or provincial – should take the lead in establishing priorities for economic and social policy in Canada. The review of the fiscal arrangements at five-year intervals provides a forum in which each government tries to set priorities for social and economic policy in consultation with other governments. As a result, the fiscal arrangements have a great deal to do with issues that basically have to do with political power and the role that each level of government is perceived by the public to play in the delivery of social and economic programs.

The Effective Provision and Financing of Public Services

Many Canadians believe that there are inefficiencies in the provision and financing of public services in Canada. This broad issue is specifically applicable to the programs carried out under the Fiscal Arrangements Act. Some people stress a need for greater provincial control over these programs; others call for a more direct role by the federal government in the maintenance of national standards.

The Stability of Government Revenues

One of the goals of the fiscal arrangements is to provide a measure of stability to provincial government revenues. The importance of the fiscal arrangements to some of the provincial governments underlines the need to require that consultations be undertaken before any changes are made in these arrangements. The present Fiscal Arrangements Act, like its predecessors, already contains provisions of this sort; however, some argue that no amendments to the fiscal arrangements should be made without notification well in advance. This would be done only in consultation with the provinces. Thus provincial governments would have greater protection against an unanticipated loss of federal transfers.

The Conditionality or Unconditionality of Programs

In the Established Programs Financing arrangements that were instituted in 1977, a major change

was made with regard to financing medical care, hospital insurance, and postsecondary education. As noted earlier, prior to 1977 these programs were financed by the federal and provincial governments on a shared-cost basis, with the federal government linking its contributions directly to the costs of specific services. In 1977, under Established Programs Financing, the federal transfers for these programs became block grants, with fewer strings being attached to the type of services the provinces ultimately provided.

The advantages and disadvantages of each system of financing still remains an issue today. Some people contend that the unconditional nature of the current arrangements does not ensure the maintenance of national standards in health services or the adequate financing of postsecondary education. Others maintain that the provinces are in a better position than the federal government to determine the kinds of health and postsecondary education programs appropriate for their citizens and thus there should be fewer strings attached to federal transfers.

The Equalization Program

The rapid increases in world petroleum prices over the past decade have led to a series of amendments and modifications to the formula for calculating federal transfers or entitlements to provinces under the Equalization Program. The massive rise in the oil and gas revenues of the producing provinces threaten to increase drastically the federal liabilities under the program. These increases have thus been modified by amendments to the Act limiting the amount of oil and gas revenues to be taken into account for purposes of the equalization formula. With oil and gas revenues accruing largely to the western provinces, the federal government would have been required to make large payments to the poorer provinces, even though it did not share significantly in those increased revenues. A number of amendments to the Act have been adopted to limit the obligations of the federal government in this respect.

The principal problem with the Equalization Program concerns its present lack of direction. Evidence of this is provided by the *ad hoc* changes that have been made in the program in recent years and the variety of proposals advanced for reform. Perhaps more importantly, the underlying purpose of the program has been called into question. It has been argued, for instance, that the regional orientation of the transfers in the program has adverse effects on the efficiency with which resources are allocated in our economy and that the system should be replaced by a "people-oriented" transfer program, such as some form of guaranteed annual income. There is clearly no agreement at present on the underlying philosophy of the Equalization Program.

It should also be noted that the Equalization Program is not the only program in the Fiscal Arrangements Act whose specific objective is to raise the revenues of "have-not" provinces. As already indicated, conditional grant programs for health and higher education were replaced in 1977 by a block grant of an equal per capita amount for each province. Some have proposed that these separate programs be combined with the Equalization Program into one integrated program, since they share the same objective.

Co-ordination, Stabilization, and Harmonization

While there may have been less emphasis recently, in the prevailing economic milieu, on the use of fiscal policy to influence economic performance, the need for co-ordinated stabilization measures has not disappeared. Since the 1950s there has been a relative shift of fiscal power from the federal government to provincial governments. Indeed, as Chart 1-1 shows, the provincial share of revenues after transfers has increased steadily since that time. Some observers contend that the ability of the federal government to implement effective economic stabilization policies has been seriously undermined as a result of this development. Conversely, there are others who argue that provincial governments lack the power necessary to carry out selective stabilization policies that fit the needs of each region.

Another long-standing debate of importance to fiscal arrangements concerns tax harmonization. Since 1947, there has been a trend away from the centralization of personal and corporate income taxes that existed during the war to a much more flexible sharing of income taxes among federal and provincial governments. Tax harmonization is primarily achieved today through the Tax Collection Agreements, as part of the fiscal arrangements. At issue are rules to prevent "double" taxation of income and other steps to avoid a return to the "tax jungle" of the 1930s. In this connection, the recent intergovernmental discussions on a "Code of Conduct" are noteworthy. It would establish broad principles of intergovernmental co-operation on tax and expenditure policies.

Welfare Dependency and Equalization

A question of dominant interest in assessing the present Equalization Program concerns the possible conflict between the goal of national economic efficiency, on the one hand, and the regional effects

of intergovernmental transfers, on the other. It has been alleged by some economists that the Equalization Program prevents the efficient allocation of resources in the economy because it leads to capital and labour being retained in areas where their productivity is low.

It is also maintained that the Equalization Program and other transfer programs have led to an unhealthy dominance of government expenditures in the economies of the "have-not" provinces, with some of the provinces becoming more and more dependent on those transfer systems – resulting in what can be called "welfare dependencies." It is alleged that "have-not" provinces are encouraged as a result to enact legislation that is detrimental to their long-term economic well-being. It is thought that the incentives embodied in the transfer systems are such that provinces do not bear the full political and economic costs of legislation that maintains regional disparities.

The Intergovernmental Review

Canada is characterized by a high degree of federal-provincial consultation and co-operation in a wide range of policy areas. The intergovernmental review of the fiscal arrangements at five-year intervals is one of many examples of such intergovernmental liaison. Important questions have been raised about the level of openness, participation, and accountability, as well as the effectiveness of decision making, in federal-provincial processes of this sort. With the nature of Canadian federalism under scrutiny during this period of constitutional debate in Canada, the appropriate role and power of governments is also at issue, especially in the area of federal-provincial relations.

The Problem of a Fiscal Imbalance

In the current negotiations on fiscal arrangements, perhaps the most controversial issue is the question of a "fiscal imbalance." Mr. MacEachen, the federal Minister of Finance, has maintained that the existence of such an imbalance is evident from the large and persistent deficit of the federal government compared with the surplus of the provinces as a whole.[2] The importance of this argument for the negotiations is paramount, since it constitutes a large part of the rationale behind the federal government's stated intention to reduce the amount of net federal transfers to the provinces by $1.5 billion over the next two fiscal years. While the rationale behind a reduction in federal transfers will be discussed later in the report, the very magnitude of the proposed reduction requires that the issue of "fiscal imbalance" be addressed in some detail at the outset.

The balance between the financial capacities of governments and the expenditures required to meet constitutional responsibilities appears to be a persistent source of contention in most federal states; Canadian experience is no exception.

This issue arises in two contexts. The first refers to the differing financial capacities of provincial governments to carry out the same constitutional functions. Because these differences in financial capacity all affect the same level of government, the problem is often referred to as one of "horizontal" fiscal imbalance. This problem is addressed in Canada by the federal Equalization Program.

The budgetary situations of federal and provincial governments over the past two decades have focused attention on a second type of possible fiscal imbalance – an imbalance between the federal government, on the one hand, and the provincial governments collectively, on the other. Because this issue relates to the financial capacities and the responsibilities of different orders of government in our federal system, it is often referred to as one of "vertical" fiscal imbalance.

This issue of vertical fiscal imbalance is one of long-standing concern. Thus, in the 1960s provincial governments argued that the most rapid growth in public expenditures was occurring in areas of provincial constitutional jurisdiction, such as health and education, while provincial revenue sources were less responsive to economic growth than those of the federal government. The alleged result of these different forces was a persistent tendency for the federal government to incur budgetary surpluses, while provincial governments experienced budgetary deficits. Provincial governments proceeded to argue that there was a limited fiscal "pie" to be divided up among all governments and that in order to rectify this fiscal imbalance, tax revenues should be transferred from federal to provincial governments. The federal government, in turn, replied that provincial governments should raise their own tax rates to finance their expanding services. While the arguments of the provincial governments were not conceded, it is nevertheless worth noting that transfers of federal income tax revenues were made in the 1960s as part of the federal contribution to shared-cost programs.

In more recent years, it has been the turn of the federal government to claim that there is "vertical" fiscal imbalance in Canada. For the first time in the history of the Fiscal Arrangements Act, the federal government is approaching renewal of the Act in 1982 with the view that federal transfers to provinces should be reduced.

In analysing the question of an imbalance between levels of government in Canada, a distinction should be made between a long-term economic problem that requires substantial *structural* adjustment and a problem that needs to be resolved through political decisions with respect to social policy.

In order to say that there is a "structural" economic problem relating to a fiscal imbalance, it must be argued that one of the levels of government does not have access to the revenues required to fulfill its obligations to the citizens of the nation under the Constitution. There is no question, however, that both levels of government in Canada today have access to all major revenue sources. Thus the correction of a fiscal imbalance at one level of government is primarily a matter of raising taxes, restraining expenditures, or both. In Canada, then, the issue of a fiscal imbalance can hardly be called a long-term "structural" economic problem.

While this imbalance may not be structural, it does not mean that the issue of an imbalance does not require hard political and social choices. It is hardly comforting for policy makers to hear that all the particular government has to do to eliminate a deficit is to reduce its expenditures or increase taxes, or both.

In this context, there remain some difficult issues to be examined when discussing the question of fiscal imbalance. There is, for example, the issue of whether the fiscal arrangements have been a cause of the deficit position of the federal government or whether it would be appropriate to reduce federal transfers to the provinces in order to cure the imbalance. Some people argue that the programs in the fiscal arrangements were conceived under much better economic circumstances than exist today, particularly at the time of the 1972 and 1977 negotiations. For this reason it is said that the amount of federal transfers to the provinces should now be re-examined.

To determine the validity of these claims, it is helpful to review the nature of the federal deficit and its causes. In general, a deficit arises when total expenditures exceed total revenues at any one point in time. As such, any program that contributes to the expenditures of the federal budget must bear some responsibility for the current federal deficit.

What role have federal transfers to the provinces played in the expenditures of the federal budget? Table 1-2 shows the percentage distribution of federal current expenditures, excluding interest payments, for the years 1960 to 1981, together with

Table 1-2

Distribution of Federal Expenditures, Excluding Interest Payments, by Type of Expenditure, Canada, 1960-81[1]

	Goods and services	Transfers to persons	Transfers to governments	Other	Total	Federal surplus or deficit (-)
			(Per cent)			($ Millions)
1960	42.1	34.2	17.2	6.5	100	-229
1961	42.4	32.9	18.5	6.2	100	-410
1962	42.3	33.2	17.9	6.5	100	-507
1963	40.6	33.1	18.2	8.0	100	-286
1964	40.4	32.9	18.4	8.3	100	345
1965	39.6	32.3	20.0	8.1	100	544
1966	40.0	30.4	20.4	9.3	100	231
1967	38.4	31.4	21.5	8.7	100	-84
1968	37.6	31.9	23.0	7.5	100	-11
1969	37.2	31.6	23.9	7.3	100	1,021
1970	35.2	31.4	26.3	7.2	100	266
1971	33.3	31.4	29.0	6.3	100	-145
1972	31.6	35.9	26.4	6.1	100	-566
1973	31.7	36.5	25.1	6.7	100	387
1974	29.7	34.9	24.7	10.7	100	1,109
1975	27.2	34.6	25.0	13.2	100	-3,805
1976	29.3	34.9	25.8	10.0	100	-3,391
1977	29.7	34.9	26.5	8.9	100	-7,303
1978	29.0	35.4	26.3	9.3	100	-10,654
1979	29.2	33.6	26.9	10.3	100	-9,213
1980	27.4	33.1	25.6	14.0	100	-10,697
1981	27.1	32.2	25.8	14.9	100	-6,674

1 Data are actual for 1960 to 1980 and projected for 1981.
SOURCE Based on data from Statistics Canada.

the surplus or deficit for each year. While federal transfers to other levels of government account for a large portion of total federal spending (about 25 per cent), there is no reason to suggest that these expenditures played a particularly significant role in the escalating federal deficit during the period 1975-81, as set out in Column 6 of Table 1-2. Federal transfers to other levels of government accounted for a roughly constant proportion of total federal spending (excluding interest payments) throughout this period. In fact, there has been little change in the shares of any one of the broad expenditure categories as a proportion of total federal expenditures over this period.

If expenditures, including those relating to federal transfers to the provinces, are not a "cause" of the deficit, there must be reason to seek an explanation on the revenue side. While federal government expenditures, as a whole, remained around 21 per cent of gross national expenditure from 1975 to 1981, total federal revenues declined gradually from 19 per cent of GNE in 1975 to 16 per cent in 1978 and 1979. It is clear, therefore, that the emergence of an escalating federal deficit in the latter part of the last decade is more appropriately associated with declining federal revenues than increasing federal expenditures.

What are the main causes for this decline in federal revenues? To a large extent the change in the federal deficit position over the 1975-80 period can be attributed to weakness in the economy. Poor economic performance tended to reduce revenue collections, while it led to higher expenditures on such programs as unemployment insurance. This relationship between economic performance and the deficit is often described as the result of certain automatic fiscal stabilizers built into federal economic policies. According to Economic Council estimates based upon the CANDIDE econometric model,[3] more than 60 per cent of the federal deficit in the current year may be attributable to the fact that the economy is not operating at its full-employment potential.

Aside from the effects of poor economic performance on the federal deficit, the federal government has significantly reduced its flow of revenues by the introduction of a variety of discretionary tax measures since 1972. The cumulative effect of these measures was to reduce by more than $14 billion the revenue that would otherwise have been collected by the federal government in 1979. Also, the effect of indexing personal income tax, as introduced in 1973, was to decrease federal revenues from this source by some $6 billion in 1979.[4]

To present a fair appreciation of the deficit and its causes, it is necessary to examine the effect of one other expenditure program. The federal policy of subsidizing oil imports through the Oil Import Compensation Program has cost the federal government, on average, over $1 billion for each year since 1974. Prior to 1980, however, these expenditures were generally more than offset by the combined revenues from the oil export tax, the petroleum compensation charge, and the excise tax on gasoline. It was only in 1980, as indicated in Table 1-3, that the balance on the federal government's petroleum-related accounts turned substantially negative.

It is important to stress that the federal government has taken action that will significantly reduce the cost of the Oil Import Compensation Program and greatly increase its flow of revenues from taxes imposed on the petroleum sector. One of the effects of the National Energy Program, along with the new energy pricing agreements reached with the oil- and gas-producing provinces, is to substantially improve the

Table 1-3

Petroleum-Related Federal Revenues and Expenditures, Canada, 1973-80

	Revenues			Expenditures		
	Oil export tax	Gasoline excise tax	Petroleum compensation charge	Oil import compensation payments	Syncrude levy	Balance of petroleum-related accounts
			($ Millions)			
1973	83	-	-	-	-	83
1974	1,618	-	-	886	-	732
1975	1,121	222	-	1,692	-	-349
1976	700	634	-	1,054	-	280
1977	476	585	-	922	-	139
1978	294	567	37	644	9	245
1979	718	428	318	1,134	296	34
1980	850	441	766	2,969	956	-1,868

SOURCE Based on data from Statistics Canada.

budgetary outlook for the federal government in this decade.

The fiscal positions of the provinces also have to be considered in any examination of the existence of vertical fiscal imbalance. While there are prospects for substantial improvement in the fiscal position of the federal government, the majority of provincial governments can expect to experience increased deficits over the next five years. The extent to which this is so is particularly clear when we distinguish the current and future fiscal prospects of Alberta, British Columbia, and Saskatchewan from the rest of the Canadian provinces. If the oil and gas revenues, which are now largely accruing to these three western provinces, are removed from the provincial sector as a whole, the effects of this distinction become apparent. Subtraction of the estimated oil and gas royalties from the provincial sector results in a projected provincial deficit of considerable magnitude – increasing from $3 billion in 1981 to $9 billion in 1986.[5] These estimates provide an approximate indication of the fiscal situation to be faced over the next decade by those provinces which do not produce oil and gas, but they do not take into account the differences between provinces. The fiscal positions of some of the poorer provinces will be even more seriously affected than these estimates indicate.

In light of this analysis of the federal deficit as it relates to the question of vertical fiscal imbalance, the Council sees no compelling argument in support of the federal government's proposed reduction in net transfers to the provinces. The proposed reduction is nevertheless discussed later in the report in terms of specific programs under the fiscal arrangements, and our recommendations follow from that analysis.

Outline of the Report

Briefly summarized, the contents of the remainder of this report are as follows. Chapters 2 through 5 treat issues relating to the Equalization Program. The program's objectives, and performance in relation to those objectives, are assessed. Alternative principles that could be used as a guide for the program are also evaluated. Since the equalization of resource revenues or "rents" accruing to the provinces has led to fundamental problems in the program, the matter of the appropriate treatment of these revenues is discussed at length. Chapters 6 and 7 deal with the Established Programs Financing arrangements and with the future of federal transfers in the related areas of health and education. Chapters 8 and 9 concern two issues of economic policy co-ordination that are affected by the fiscal arrangements: the conduct of stabilization policy, and the objectives of taxation and fiscal harmonization. Chapter 10 examines questions about the federal-provincial process by which the fiscal arrangements are reviewed every five years. Chapter 11 presents the conclusions and recommendations of the report.

2 The Equalization Program: Background, Objectives, and Performance

Canada's program of federal equalization payments to the provinces has been referred to as the "glue" that holds the country together. It has become one of the major vehicles for intergovernmental redistribution of revenues in Canada. The fundamental goal of the Equalization Program is to ensure that, through the provision of sufficient financial means, all provinces will have the opportunity to provide reasonably comparable levels of public services to their citizens at reasonably comparable levels of taxation. This objective is achieved by the transfer of federal tax revenues to the less financially affluent provincial governments.

In 1980/81, the estimated federal government outlays on this program amounted to $3.4 billion. They accounted for roughly 5 per cent of total gross federal expenditure and for nearly 28 per cent of cash transfers from the federal to provincial governments.

The program has greatly increased in importance over time. When it was first introduced in 1957, payments to the provinces under the program were equivalent to 0.4 per cent of gross national expenditure. By 1980, these payments had grown to more than 1.1 per cent of GNE.

The program is of special importance to particular provincial governments. Equalization payments constitute the single largest source of funds for governments in the Atlantic provinces, accounting for 21 to 26 per cent of the total general revenues of these governments in 1980/81. The program accounts for lesser, but still significant, proportions of the revenues of the governments of Manitoba and Quebec.[1]

That the Equalization Program has become a special part of the fabric of the nation was indicated by the unanimous agreement of all governments in 1980 to enshrine the concept in a new Canadian Constitution. A provision aimed at achieving that objective was included in the proposed Act to amend the Constitution of Canada, which was introduced in Parliament by the federal government early in 1981.

The remainder of this chapter outlines the origin and development of the Equalization Program, explains its mechanics, evaluates its achievements in relation to its objectives, and outlines problems that have arisen with the program – problems that will be considered at greater length in subsequent chapters.

Origin of the Program

Since Confederation, statutory subsidies have been paid by the federal government to the provinces to help them cover their expenditures. But the principle of equalization was first put forward explicitly in Canada in what is universally agreed to have been one of the most remarkable documents on intergovernmental relations ever produced in any federal state: the 1940 *Report of the Royal Commission on Dominion-Provincial Relations*.[2] The Commission proposed the establishment of a system of national adjustment grants to achieve one of its central objectives, which it described as follows:

> They are designed to make it possible for every province to provide, for its people, services of average Canadian standards and they will thus alleviate distress and shameful conditions which now weaken national unity and handicap many Canadians. They are the concrete expression of the Commission's conception of a federal system which will both preserve a healthy local autonomy and build a stronger and more united nation [p. 125].

More specifically, the Commission recommended that national adjustment grants be paid:

> whenever a provincial government established that it could not supply Canadian average standards of service and balance its budget without taxation (provincial and municipal) appreciably exceeding the national average in relation to income [p. 83].

While the Commission considered that these grants should enable the less affluent provinces to provide an average level of public services without the need to resort to excessively high levels of taxation, it also believed that they should be completely unconditional. The Report underlined the point succinctly:

> If a province chooses to provide inferior services and impose lower taxation it is free to do so, or it may provide better services than the average if its people are willing to be taxed accordingly, or it may, for example, starve its roads and improve its education, or starve its education and improve its roads [p. 84].

Part of the rationale developed by the Commission in support of the proposed system of national adjustment grants broke new ground. While it did not use the term, the Commission in effect advanced the concept of what is often referred to today as "horizontal fiscal equity." This means simply that the burdens and benefits of provincial and municipal services should be reasonably comparable for Canadians in similar circumstances regardless of where in the country they live.

The Commissioners were well aware that their recommendations represented a clear break "from the traditional subsidy system and the principles ostensibly underlying it" [p. 125]. In defence of their proposals, they pointed out that the degree of regional inequality evident in the 1930s had not existed at the time of Confederation and that a large part of the responsibility for this state of affairs fell squarely on the shoulders of the federal government. They contended that the "national policy" of high tariff protection adopted soon after the founding of the nation drastically altered the economic development of the country and that of each individual region within it. Furthermore, the Commission expressed the view that the provinces had implicitly joined in a contractual arrangement in 1867 under which they agreed to share the benefits as well as the economic costs associated with the overall growth of the nation [pp. 78-79].

The Commission's recommendations for national adjustment grants were only part of a comprehensive set of reform proposals addressed to problems of government finance that had been accentuated by the Great Depression. With the objective of increasing efficiency in the allocation of national resources, the Commission recommended that the provinces give up their powers to levy personal income taxes, corporate taxes, and succession duties – powers that, in the Commission's opinion, had led to the creation of a "tax jungle" in the 1930s. While national adjustment grants themselves would partially compensate for the loss of these revenue sources, the Commission proposed in addition that the federal government assume the accumulated net debt of the provinces and the burden of certain provincial responsibilities – the most important being unemployment relief.

It is well to recall that at the time the Commission wrote its report economic data – especially on the provincial economies – were virtually non-existent, and the conduct of public finance as an economic tool might be fairly regarded as having been in its infancy. Given these circumstances, it is remarkable (and a tribute to the insight of its members) that the principles advocated by the Commission with respect to equalization have endured the passage of time. There is virtually no difference between the stated objectives of the Commission's proposed national adjustment grants, those of the Equalization Program instituted in 1957, and those related to incorporation of equalization in the proposed Constitution.

The immediate reception accorded to the Commission's proposals was rather less positive than the verdict of the vast majority of Canadians after 40 years; the proposals were rejected by some provinces at federal-provincial meetings during 1940 and 1941. The advent of the Second World War, however, led to postponement of further consideration of the issues raised by the Commission.

The system of federal-provincial finance adopted during the war, and its extension during the early postwar years, did, however, contain an element of equalization. The provinces temporarily surrendered to the federal government their power to levy personal and corporate taxes and succession duties as part of the wartime financial arrangements. For the "rental" of these three tax fields, the provinces were compensated by payments from the federal government. Two alternative formulas were offered for determining the amount of compensation that each province would receive. They were: 1/ the revenue yield within the province in 1941 from vacated tax fields; or 2/ the net cost of servicing the provincial debt for the fiscal year 1940/41, less succession duties collected in that year.

Saskatchewan and the Maritimes chose the latter option, with the result that the compensation paid these provinces by the federal government significantly exceeded the revenues they would have generated by levying their own personal and corporate income tax and succession duties. It is for this reason that the period of the Tax Rental Agreements is sometimes referred to as one of "implicit" equalization.

The 1957 Equalization Program

The principle of equalization was explicitly incorporated into the final set of Tax Rental Agreements covering the years 1957-62. Under this new arrangement, all provinces, with the exception of Ontario and Quebec, continued to vacate the fields of personal and corporate income taxes, and of succession

duties. (Quebec chose not to rent out its personal income tax field, while both Ontario and Quebec retained corporate taxation.) At the same time, however, the federal government also undertook to provide grants to the provincial governments, to bring the level of per capita yield from personal and corporate income taxes and succession duties up to that of the average of the yield from these taxes in the two wealthiest provinces. Under the 1957 agreements, equalization was received by all provinces with the exception of Ontario.

At the time the 1957 agreements were being negotiated, there was a widespread consensus, at least among the "have-not" provinces, that federal payments designed to equalize revenues only through the three "standard" taxes would result in the perpetuation of substantial fiscal disparities among the provinces. The federal government responded to this concern by making special provision for the four eastern provinces through what was termed "the Atlantic Provinces Adjustment Grants." These grants continued to be paid to the Atlantic provinces until the equalization formula was extended in 1967 to cover all major provincial revenue sources.

It is worth noting that the new Equalization Program simply compensated "have-not" provinces for deficiencies in revenue-raising capacity. This feature of the program has endured over the years. Despite the formal objectives of the program, no attempt has ever been made to define "needs" for reasonable levels of provincial public services: the operational objective of the program has always been to "*raise the fiscal capacity of 'have-not' provinces.*"

Another important feature of the new program was that while it was intended to remedy deficiencies in *provincial* revenue capacities, it was established by the federal government and was financed out of *federal* revenues. In this respect, the program's format followed the recommendations of the Rowell-Sirois Commission. While to most Canadians it might appear that such an approach is inescapable, in fact there are other alternatives. In the year before the Equalization Program was instituted, the Quebec Royal Commission of Enquiry on Constitutional Problems (the Tremblay Commission) suggested that an equalization system could involve direct redistribution between provincial governments. One federal state – West Germany – has adopted equalization programs under which redistribution occurs *directly* between the richer and poorer German state governments. Under the West German system, moreover, it is obvious that the direct benefits to recipient governments and their citizens are balanced by direct costs to donor states and their taxpayers. As will be noted, the regional impact of benefits and costs is far less obvious in the case of the Canadian program, and the fact that it is solely financed by the federal government has been a source of some of its subsequent difficulties.

Major Changes in the Program since 1957

The Equalization Program comes up for renewal every five years, and substantial revisions have occurred in its make-up at these intervals and even during the years in between. Significant changes have occurred with respect to the revenue standard to be achieved by equalization and the comprehensiveness of revenue sources covered by the program. In some instances, changes were made in both dimensions simultaneously.

Two significant pairs of changes were introduced to the Equalization Program between 1962 and 1964. In 1962, at the outset of the second five-year period in the program's history, 50 per cent of natural resource revenues were brought into the formula. The immediate effect of this change was to reduce equalization payments to Alberta and British Columbia but to increase somewhat the amount of payments to provinces that had negligible revenues from this source. At the same time, however, the standard of equalization was reduced from that of the two wealthiest provinces to that of the national average. The net effect of these two changes was essentially neutral for provinces that were eligible for equalization and had relatively low resource revenues, but the changes did result in making Alberta and British Columbia ineligible to receive payments. In the case of these two provinces, it was the view of the federal government that they had sufficient access to revenues of their own and thus required no further equalization transfers.

In 1964, the standard of equalization reverted back to that of the two wealthiest provinces, apparently in response to increasing political pressure from the "have-not" provinces. The treatment of natural resource revenues in the equalization formula was also changed again. It was stipulated that to the extent that any province received a per capita yield from this revenue source that was above the national average, its entitlement to equalization would be reduced by 50 per cent of that amount. While the first of these two changes sparked a general increase in equalization payments, the change with respect to natural resource revenues continued to make both Alberta and British Columbia ineligible.

The major watershed in the program occurred in 1967, however, when equalization was extended to include almost all provincial government revenue

sources, including 100 per cent of natural resource revenues. This change, which increased the number of revenue sources in the formula from 4 to 16, represented a serious effort to calculate equalization payments on the basis of a comprehensive measure of provincial revenue capacity. While the tendency for this amendment alone was to increase substantially the level of equalization payments, it was partially offset by steps taken simultaneously to reduce the standard of equalization to that of the national average, where it has remained ever since. Nevertheless, the net effect was to increase equalization payments to the receiving provinces, the majority of which had yields from the newly added revenue sources that were significantly below the national average on a per capita basis. Equalization payments increased from roughly $335 million in 1966 to $545 million in 1967, constituting the largest relative increase in payments throughout the program's history.

Perhaps just as important as these technical changes themselves was the change in the underlying federal philosophy. With respect to the function of equalization payments, the Honourable Mitchell Sharp, then Minister of Finance, noted that the federal government should "enable each province to provide an adequate level of public services without resort to rates of taxation substantially higher than those of other provinces."[3] This was essentially identical to the objectives embraced by the Rowell-Sirois Commission almost 30 years earlier. Finance Minister Sharp concluded by saying that the federal government could come closest to reaching these objectives by adopting a formula that would "take into account all of a province's revenues and equalize them to the national average." Bearing in mind this objective – raising the total revenue capacity of all provinces to the national per capita average – we shall evaluate the performance of the Equalization Program at a later stage.

There was one particularly important area, however, in which the Equalization Program introduced in 1967 differed from that envisaged by the Rowell-Sirois Commission. The Commission had proposed that the revenue capacity of municipal as well as provincial governments be evaluated in the determination of national adjustment grants. The federal government, however, chose to leave municipal revenues out of the 1967 equalization formula, arguing that there was no suitable measure available to determine the base for the real property tax.

While the number of revenue sources to be equalized increased from 16 to 19 as the result of a further delineation of tax fields in 1972, the next major change in the formula did not occur until 1973, when revenues from the school-purpose tax were also included for equalization purposes. This revenue source constituted the first local government revenue to be included in the formula. Evidently the federal government had by this time come to the conclusion that the objectives of the Equalization Program required at least partial consideration of the fiscal abilities of provincial and local governments combined.

No additional revenue sources have been added to the Equalization Program since 1973; however, subsequent reclassifications of revenues since that year have increased the number of revenue categories to 29.

Attempts to Limit Total Equalization Payments

The third set of major changes in the program over time have been made in connection with measures to *limit* the net cost of the program to the federal government. These changes have primarily arisen in the treatment of natural resource revenues – particularly revenues from non-renewable resources.

The inclusion of natural resource revenues of provincial governments in the formula for purposes of calculating equalization payments has long been a source of some difficulty. Indeed, the history of equalization since 1973 has been dominated by increases in provincial oil and gas revenues and by a succession of attempts on the part of the federal government to prevent these revenues from substantially increasing the costs of the Equalization Program. Increased natural resource revenues have resulted not only from the increases in the wellhead price of domestic oil and gas that followed the upsurge in world petroleum prices that began in 1973 (plus any benefits that the producing provinces reaped from still higher export prices), but also from increases in the royalty levies imposed by provincial governments and from the higher returns on the leasing of provincial Crown land for exploration and development. The effect of this substantial rise in the resource-related revenues of the western provinces, particularly Alberta and British Columbia, was to increase significantly the liability of the federal government to all provinces receiving equalization payments, except Saskatchewan, because the yield of these provinces from similar tax sources was minimal by comparison.

In 1974, the federal government stipulated that only one-third of provincial oil and gas revenues resulting from the *increase* in prices above the 1973 level would be taken into account for the purpose of calculating equalization payments. Revenues that

would have been derived had the "old" price levels prevailed continued to be fully equalized.

In 1977, the formula was changed again to provide that only half of provincial revenue from *non-renewable* natural resources could be taken into account for equalization purposes. The federal government further decreed that no more than one-third of total payments could arise from equalization of all *natural resource* revenues. Because the recent increases in oil and gas prices have been so substantial, it is considered that this ceiling could become effective as early as 1982. Finally, Ottawa declared that revenues from the sale of Crown leases, which reflect payments for oil exploration rights, would be phased out of equalization in two stages, with one-half to become ineligible for equalization in 1979/80 and the remainder, in 1980/81.

The Ontario "Rider"

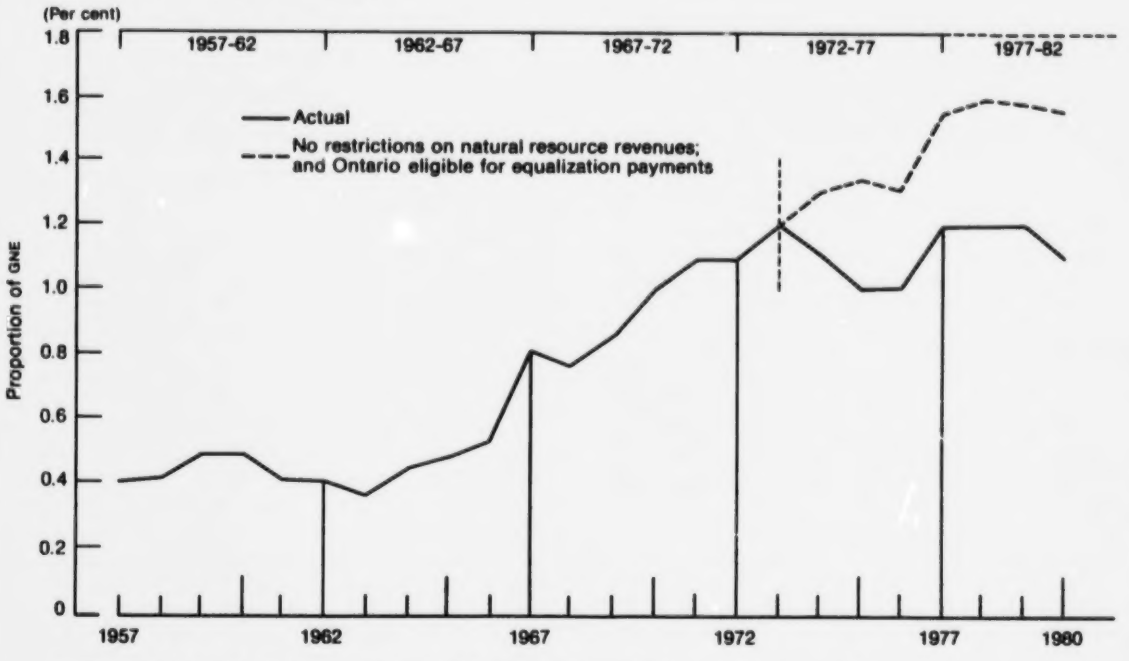
Ontario is the only province that has never been a recipient of equalization payments. Even with the restrictions imposed during the mid-1970s on the eligibility of non-renewable natural resource revenues for equalization purposes, however, Ontario would have become eligible to be a recipient in 1977 because its own potential for revenue from these sources was – like that of the provinces receiving equalization payments – comparatively small on a per capita basis. To prevent Ontario from qualifying for equalization grants, legislation was introduced in Parliament in 1978 to preclude payment of equalization grants to any province whose personal income per capita had been above the national average in both the current and two previous years. Although this legislation was only passed in 1981, regulations designed to achieve the same purpose prevented Ontario from receiving any interim payment of equalization payments in the years 1977 to 1980. It is estimated that Ontario would have been eligible to receive nearly $500 million in such payments for the fiscal year 1979/80 had this regulation not been in effect.

The Financial Consequences of Changes in the Equalization Program

Chart 2-1 illustrates the financial consequences of the major changes in the Equalization Program

Chart 2-1

Equalization Payments as a Proportion of Gross National Expenditure, Fiscal Years 1957/58 to 1980/81



SOURCE Calculations by the Economic Council of Canada, based on data from the Department of Finance.

outlined above. It shows the sharp increase in payments in relation to gross national expenditure that took place following the program modifications in 1967, which significantly increased the number of provincial revenue sources covered by the equalization formula. The broken line in the chart shows the extent to which payments might have increased even further during the 1970s in the absence of the measures adopted by the federal government to limit the inclusion of natural resource revenues for equalization purposes and to exclude Ontario from receiving payments to which it would otherwise have been entitled.

Exactly why it is that natural resource revenues have had such an enormous effect on the growth of equalization payments cannot be fully appreciated without some detailed explanation as to how equalization is calculated under the current program. The mechanics of the equalization formula will now be examined.

The Calculation of Equalization Payments

The basic objective of the Equalization Program is to provide payments to those provinces whose ability to raise revenues, as determined on the basis of a comprehensive examination of provincial revenue sources, is below that of the national per capita average. As noted previously, the current formula takes account of 29 different revenue sources and, with the exception of grants, debt funding, and municipal property taxes other than for school purposes, covers all major sources of provincial revenue.

An important element of the program is the choice of a base for equalization purposes covering each of the 29 revenue sources that accurately reflects the base upon which taxes are actually applied within the provinces. In the case of personal income tax, the base chosen is the same as that defined for federal personal income tax purposes. The choice of a base in other instances, however, is made considerably more difficult by virtue of the fact that the provinces do not follow identical taxation practices; moreover, no readily available measure for the base upon which taxes are imposed exists that is consistent from province to province.

In the equalization formula, the ability of a province to raise revenues – or its revenue capacity – with respect to any particular source is measured on the basis of that province's share of the total revenue base. Once this fundamental aspect of the equalization formula is understood, the actual mechanics of calculating equalization payments are quite straightforward. The calculation of equalization payments takes place in two stages. In the first stage, comparative provincial revenue capacities for each of the 29 revenue sources are calculated by subtracting a province's share of the base for a particular revenue source from its share of the total population. When the outcome is positive – that is, when a province's share of total population exceeds its share of the total revenue base – a fiscal capacity "deficiency" is said to exist. Conversely, when a province's share of the total revenue base exceeds its share of total population, a fiscal capacity "excess" is said to exist. These fiscal capacity "excesses" or "deficiencies" are then multiplied by the total provincial revenue collections from each associated revenue source to arrive at a positive or negative equalization "entitlement," as the case may be, for each category of revenue.

Quebec, for example, has roughly 27 per cent of the total population and has 24 per cent of the total provincial revenue base for personal income tax. That province, therefore, has a "deficiency" in this revenue source of 3 percentage points. Multiplying the latter by the sum of provincial revenues collected under the personal income tax (about $10 billion) yields a positive equalization entitlement to the province of Quebec of approximately $300 million. Quebec, on the other hand, has a revenue "excess" with respect to revenues from the sale of tobacco products and is thus accorded a negative equalization entitlement in the case of this revenue source.

In the second stage, positive and negative equalization entitlements are aggregated over the entire 29 revenue categories for each province. The resulting sum, if positive, is paid to a province in the form of an equalization payment. If this adding-up procedure produces a negative sum, as is currently the case for two provinces, no transfers are made. Because equalization is funded from federal revenues, no direct transfer takes place between "revenue-rich" and "revenue-poor" provinces. This does not mean, however, that the Equalization Program is of no financial consequence to the non-receiving provinces, as will be explained later in this chapter.

By far the largest source of income subject to equalization is that derived from personal income tax, which in 1980/81 resulted in equalization entitlements of roughly $1 billion. But while revenues subject to equalization under the personal income tax are almost 10 times as large as revenues subject to equalization with respect to Crown petroleum revenues, the equalization entitlements from the latter revenues amounted to almost half of those from personal income tax. This is because production of

oil and gas is largely confined to the three most westerly provinces. Large provincial revenue deficiencies exist for the other provinces, whose share of the base, with respect to this particular revenue source, is negligible. As a result, the provinces that do not produce oil and gas qualify for very large equalization entitlements from this revenue source notwithstanding the limitations imposed by the federal government on the application of the general formula. While a $1 increase in provincial revenue entering the equalization formula from personal income tax would generate 8 cents in equalization payments at the present time, a similar increase of $1 in provincial petroleum revenues would bring about an increase in equalization payments of 35 cents.

The measurement of provincial revenue capacity and the determination of equalization entitlements under the current formula is obviously very sensitive to the actual taxing practices of provincial governments in total (although not significantly with respect to any one province in isolation). Total provincial revenue collections with respect to a particular revenue source fluctuate both with changes in the magnitude of the tax base and with the rate of taxation imposed on it. This fact is accurately reflected in the term used to describe the formal basis of the current Equalization Program, "the representative tax system."

It may seem obvious that the nature of existing provincial tax structures should weigh heavily in the calculation of provincial revenue capacity. It should be pointed out, however, that there are alternative approaches to measuring provincial revenue capacity; one in particular – the "macro-economic approach" – has recently gained considerable attention. The latter utilizes a single proxy for aggregate provincial economic activity, such as personal income or gross domestic product, as a measure of revenue capacity. Schemes of this nature have attracted interest because they offer a fairly comprehensive measure for comparing differences in provincial wealth. The relevance of such schemes to the measurement of provincial revenue capacity is severely constrained by their failure to recognize that governments obtain revenue more easily from some tax sources than from others. For example, a dollar of wage income and a dollar of profit from the production and sale of oil and gas, while carrying equal weight in the determination of a province's total income, have clearly different revenue potentials. This follows because the real consequences associated with imposing high tax rates on oil and gas revenues (which may largely consist of economic rents or revenues over and above the costs of production) may be marginal owing to the immobility of these critical resources; that is, they cannot relocate in another province.

Evaluation of the Equalization Program

The stated objective of the Equalization Program is to give recipient provinces the opportunity to provide reasonably comparable levels of public services without having to resort to exorbitant tax rates relative to those of other provincial governments. The purpose of this section is to assess the extent to which this objective has been met. The focus of the evaluation is on one particular variable – the revenue capacity of the provinces.

In support of this approach, it might be noted that the objective of the program has never been to finance any particular mix or package of public services. Recipient provinces are free to spend equalization payments any way they choose; indeed, they may pass the monies on to their residents in the form of tax relief. In this sense, the Equalization Program may be interpreted as having a very general goal – namely, that of reducing the differences in fiscal opportunities among provinces.

The equalization formula that was incorporated in the Fiscal Arrangements Act of 1967 provided for equalizing the yield of all provincial revenues up to the national average. Although the restrictions placed on the formula since 1967 have caused this explicit objective to be abandoned, we have nevertheless chosen to evaluate the performance of the current program against this standard. In what follows, then, we attempt to indicate the impact of the current Equalization Program on the revenue capacities of each individual province in relation to the average revenue capacity of all provinces. Because provincial governments receive large amounts of revenue in the form of federal transfers other than equalization, we have extended the analysis to take account of the impact of all federal transfers on provincial revenue capacity.

In evaluating the performance of the Equalization Program, we have adopted two separate approaches. The first approach involves calculating the effect of equalization and other federal-provincial transfer programs in augmenting the "own-source" revenues of provincial governments – that is, the revenues that the provinces are able to raise from their own revenue sources alone. This is the conventional yardstick that is applied to measure the *gross* impact of federal transfers on the financial capacity of provincial governments. The second approach we have adopted takes the process one step further by calculating the estimated amount of revenue that has to be raised from federal taxpayers in each province

by the federal government to finance the cost of these transfer payments to provincial governments. These offsetting costs are then weighed in the balance in order to estimate the *net* effect of federal transfers on the financial capacity of the provinces. The first of these methods of calculation is referred to as the "gross" approach; the second, as the "net" approach.

Evaluation under the "Gross" Approach

Three measures of relative provincial revenue capacity are presented in Table 2-1. The basis for each of these measures is provincial "own-source" revenues, which we calculate by applying national average tax rates to the associated provincial tax base for all major provincial revenue sources. Included in the calculation of the latter is 100 per cent of natural resource revenues, as well as revenues from all local property taxes. In each case, provincial revenues have been standardized – that is, calculated on a per capita basis and expressed in index form, with the national average equal to 100.

Column 1 shows provincial revenue capacity based upon "own-source" revenues alone. The range in provincial "own-source" revenue capacities is between 53 per cent of the national average in the case of Prince Edward Island and 232 per cent of the national average in the case of Alberta. Four of the ten provinces have provincial revenue capacities below 65 per cent of the national average, while only two provinces have revenue capacities significantly greater than the national average. In the case of Alberta, this province has an "own-source" revenue capacity of more than twice the national average.

The second column in Table 2-1 takes into consideration own-source revenues plus those revenues which the provinces receive in the form of equalization payments. It is evident from Column 2 that while the Equalization Program greatly narrows the dispersion between provincial revenue capacities it falls far short of raising the revenue capacity of all provinces up to that of the national average. The program raises the revenue capacities of Manitoba and Quebec to 87 and 86 per cent of the national average, respectively, while raising the revenue capacities of the Atlantic provinces to roughly 83 per cent of the national average. In examining these results, it should be emphasized that the standard of provincial revenue capacity against which we have measured the performance of this program is one based on a consideration of all provincial revenue sources. The Equalization Program, on the other hand, only takes partial account of natural resource revenues and local property taxes.

Generally speaking, those provinces which have the lowest own-source revenue capacities experience the greatest percentage change because of equalization, as indicated by Column 3 in Table 2-1. Prince Edward Island, for example, with an own-source revenue capacity of 53 per cent of the national average, shows an increase in its revenue capacity of 55 per cent. Quebec, however, with an own-source revenue capacity of 78 per cent – relatively high among the "have-not" provinces – experiences an

Table 2-1

Change in Provincial-Local Revenue Capacity as a Result of Equalization Payments or Total Federal-Provincial Transfers: The "Gross" Approach, Canada, by Province, 1980/81

	Own-source revenues	Own-source revenues plus gross equalization payments	Change in revenue capacity[1]	Own-source revenues plus total gross federal-provincial transfers	Change in revenue capacity[2]
			(Per cent)		
Newfoundland	58	84	45	87	50
Prince Edward Island	53	82	55	92	74
Nova Scotia	64	83	30	86	34
New Brunswick	63	84	33	88	40
Quebec	78	86	10	90	15
Ontario	92	86	-7	88	-4
Manitoba	77	87	13	88	14
Saskatchewan	104	99	-5	99	-5
Alberta	232	216	-7	193	-17
British Columbia	113	106	-7	104	-8
Canada (excl. the Territories)	100	100	-	100	-

1 Calculated as follows: col. 2 minus col. 1 divided by col. 1.
2 Calculated as follows: col. 4 minus col. 1 divided by col. 1.
SOURCE Estimates by the Economic Council of Canada, based on data from the Department of Finance.

increase of only 10 per cent in its revenue capacity as a result of equalization.

The Equalization Program is progressive in terms of its impact on the six traditional "have-not" provinces; that is, it makes larger contributions to those provinces which have lower revenues from their own sources. Because of the effect of equalization in raising the relative financial capacity of these six provinces, all four of the remaining provinces – Ontario, Saskatchewan, Alberta, and British Columbia – experience a decline in their relative financial capacities, or a drop of around 7 per cent on average. The revenue capacities of the three western provinces, however, are significantly greater than that of Ontario. Indeed, Alberta's financial capacity is more than twice that of the central province. The equalization scheme, therefore, is regressive in the sense that it has the same relative impact on the financial capacity of Ontario as it has on the three wealthier provinces of the West.

The effect of all federal-provincial transfers on provincial revenue capacity is indicated in Columns 4 and 5 of Table 2-1. It is apparent that the dispersion of provincial revenue capacities is reduced still further when all federal-provincial transfers are taken into account. Furthermore, the total revenue capacities (own-source revenues plus all federal-provincial transfers) of most "have-not" provinces are raised to close to 90 per cent of the national average. On the other hand, the revenue capacity of Ontario is in the majority of cases either equal to or less than the revenue capacity of the receiving provinces when the effect of all federal-provincial transfers is taken into account.

Evaluation under the "Net" Approach

Equalization and other federal-provincial transfers are financed from the general revenues of the federal government. This revenue is raised mainly from

Table 2-2

Estimates of Net Federal Transfers to Provinces, Canada, 1980/81

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Total
						($ Millions)					
Equalization payments	376	88	449	379	1,721	-	343	40	-	-	3,396
Federal tax contributions[1]	31	8	86	58	732	1,467	116	120	389	389	3,396
Net transfers	345	80	363	321	989	-1,467	227	-80	-389	-389	-
Other federal-provincial transfers	324	92	461	411	3,781	4,415	535	516	1,124	1,420	13,079
Federal tax contributions[1]	120	30	331	225	2,819	5,652	445	460	1,498	1,499	13,079
Net transfers	204	62	130	186	962	-1,237	90	56	-374	-79	-
Total federal-provincial transfers	700	180	910	790	5,502	4,415	878	556	1,124	1,420	16,475
Federal tax contributions[1]	151	38	417	283	3,551	7,119	561	580	1,887	1,888	16,475
Net transfers	549	142	493	507	1,951	-2,704	317	-24	-763	-468	-

1 Federal tax contributions are equivalent to the provincial distribution of total federal government revenue, as reported in Statistics Canada's *Provincial Economic Accounts*.

The provincial allocation of federal revenue contained in the *Provincial Economic Accounts* has been criticized on the grounds that it may not adequately reflect the true incidence of particular taxes. The corporate tax, for example, is allocated on the basis of corporate taxable income, while customs duties are provincially distributed on the basis of "collections." Who the ultimate bearers of these and certain other taxes are, for all intents and purposes, is unknown.

We conducted a series of exercises to address this problem, in which alternative shifting assumptions were made as to the incidence of the federal personal and corporate income taxes, general sales tax, excise tax, and customs duties. These revenue sources collectively account for over 75 per cent of total federal revenue. We found that regardless of whether labour, capital, or consumption was assumed to bear the burden of any of these particular taxes, the provincial allocation of these revenues was effectively the same.

An increasingly important source of federal revenue, however, is related to western oil and gas production. This factor is not adequately captured in the *Provincial Economic Accounts* data, which did not extend beyond 1979 at the time we were conducting our analysis. We are particularly aware of the fact that the federal National Energy Program will have a significant impact on the provincial distribution of federal revenues, by province. Just how our results might have changed had it been possible to allow for these effects is virtually impossible to predict.

SOURCE Estimates by the Economic Council of Canada, based on data from the Department of Finance and from Statistics Canada.

various forms of federal taxes, the burden of which is borne to varying degrees by the federal taxpayers of all provinces. A reasonable, although somewhat arbitrary, way of allocating the "costs" of equalization and other federal-provincial transfers, by province, is to assume that they are financed in accordance with their *pro rata* share of all federal taxes. In addition to showing the actual distribution of transfer payments by the federal government to the provinces in 1980/81, Table 2-2 also provides an estimate of the cost to federal taxpayers in each province of financing those transfers. In the case of Newfoundland, for example, total federal transfers to the province amounted to $700 million, of which $376 million took the form of equalization payments. At the same time, however, federal taxpayers in Newfoundland contributed an estimated $151 million to help finance the cost of all federal-provincial transfers. Subtracting the estimated federal tax contribution of Newfoundland residents from actual transfer payments provides an indication of the "net" transfers to Newfoundland. This is shown in lines 3, 6, and 9 of Table 2-2 in the case of equalization transfers alone, federal-provincial transfers other than equalization, and all federal-provincial transfers.

While it is obvious that federal-provincial transfer programs entail a certain cost for all federal taxpayers within a province, it is not clear exactly how federal taxation affects the ability of provincial governments to raise their own revenues. To obtain some approximation of the effect, we have undertaken a fairly simple calculation. First, we have assumed that if there were no federal-provincial transfers, federal taxes would be lower by an amount equal to the cost of such programs. Second, we have assumed that a $1 reduction in federal taxes payable in any particular province would result in a similar increase in the revenues potentially available to the provincial government. While this second assumption is, of course, open to challenge, the fact is that it is just such an assumption that underlies certain of the existing federal-provincial fiscal arrangements under which the federal government reduces its own taxation and, in effect, transfers "tax points" to provincial governments. In any case, it is a reasonable assumption to make for purposes of arriving at an approximation of the net balance between equalization payments and other transfers received by provincial governments and the costs borne by the provinces for the financing of such transfers.

In evaluating the effect of the Equalization Program on provincial revenue capacity under the "net" approach, we begin by first determining what provincial revenue capacity would have been in the absence of these federal transfers. In doing so, we add provincial "tax contributions" for the purpose of financing such transfers to provincial "own-source" revenue, arriving at "adjusted own-source" provincial revenues, which are shown in Column 1 of Table 2-3. The latter serves as our point of reference for evaluat-

Table 2-3

Change in Provincial-Local Revenue Capacity as a Result of Equalization Payments or Total Federal-Provincial Transfers: The "Net" Approach, Canada, by Province, 1980/81

	Adjusted own-source revenues[1]	Adjusted own-source revenues plus net equalization payments	Change in revenue capacity[2]	Adjusted own-source revenues[3]	Adjusted own-source revenues plus total net federal-provincial transfers	Change in revenue capacity[4]
			(Per cent)			
Newfoundland	57	84	47	53	87	64
Prince Edward Island	52	82	58	51	92	80
Nova Scotia	64	83	30	66	86	30
New Brunswick	63	84	33	62	88	42
Quebec	79	86	9	79	90	14
Ontario	94	86	-9	99	88	-11
Manitoba	77	87	13	77	88	14
Saskatchewan	103	99	-4	99	99	-
Alberta	225	216	-4	206	193	-6
British Columbia	112	106	-5	111	104	-6
Canada (excl. the Territories)	100	100	-	100	100	-

1 Own-source revenues plus federal tax contributions on behalf of equalization.
2 Calculated as follows: col. 2 minus col. 1 divided by col. 1.
3 Own-source revenues plus federal tax contributions on behalf of all federal-provincial transfers.
4 Calculated as follows: col. 5 minus col. 4 divided by col. 4.
SOURCE Estimates by the Economic Council of Canada, based on data from the Department of Finance.

ing the effects of the Equalization Program. The revenue capacity in Column 2 of Table 2-3 is based upon "adjusted own-source" provincial revenues, plus net equalization. "Net" equalization, as indicated earlier, is the difference between actual provincial equalization payments and the cost of financing the Equalization Program that is borne by provincial residents.

Note that the revenue capacities in Column 2 of both Table 2-1 and Table 2-3 are identical.[4] The effect, in percentage terms, of equalization on provincial revenue capacity, as shown in Column 3 of both Tables 2-1 and 2-3, is different. This difference is explained by the fact that while our point of reference in the first approach was "own-source" revenues, the point of reference in the second approach was "adjusted own-source" revenues. The difference between these two points of reference occurs, of course, because under the first we have ignored the provincial costs of financing transfers, while under the second we have taken into account our estimate of such costs as they are borne within each province by federal taxpayers.

In the case of Newfoundland and Prince Edward Island, the positive effects of the Equalization Program appear to be slightly larger under the "net" approach than under the "gross" approach. The negative effects of this program on the revenue capacity of the resource-rich provinces, on the other hand – Alberta, British Columbia, and Saskatchewan – appear to be smaller under the "net" approach. The implication here is that the former two provinces contribute more to the financing of equalization than would be expected on the basis of their revenue capacity, while the resource-rich provinces contribute less to the financing of equalization than would be expected on the basis of their revenue capacity alone.

Note that while the negative effects of the Equalization Program appear to be smaller for the resource-rich provinces under the "net" approach, the opposite is true in the case of Ontario. Ontario suffers a decline in revenue capacity of 7 per cent under the "gross" approach and 9 per cent under the "net" approach. This finding is explained by the fact that Ontario contributes more to federal financing of equalization than would be expected on the basis of its revenue capacity alone. This is the case because the federal government does not have comparable access through its own taxation to those resource revenues that contribute so heavily to the coffers of the western provinces. While under the "gross" approach it appeared that Ontario and the three western provinces suffered similar percentage declines in their revenue capacities as a result of the Equalization Program, Ontario shows a greater decline in provincial revenue capacity than the western provinces under the "net" approach.

It is clear from our analysis of the "net" effects of equalization that the redistribution undertaken through the current program is largely from a "below-average" province in terms of revenue capacity (Ontario) to other "below-average" provinces. On the other hand, the revenue capacities of the "above-average" provinces, such as Alberta and British Columbia, are only marginally reduced. This characteristic of the Equalization Program results from two factors. First, Ontario receives no equalization payments; yet, by our measures, it is well below average in terms of its revenue capacity. Second, equalization payments are financed by resident federal taxpayers in all provinces in a manner that bears no direct relationship to provincial revenue capacity itself. The obvious implication of this is that the program would become more equitable if it were replaced by one in which provinces contributed to funding more in accordance with their levels of revenue capacity.

In order to establish the effects of all federal-provincial transfers on provincial revenue capacity under the "net" approach, we first adjust "own-source" provincial revenues to reflect federal financing for total federal-provincial transfers. The revenue capacity in Column 4 of Table 2-3 is based on provincial "own-source" revenues plus "federal tax contributions" on behalf of these transfers. Thus provincial revenue capacities *in the absence* of all federal-provincial transfers, as indicated in Column 4, range from 51 per cent of the national average in the case of Prince Edward Island to 206 per cent of the national average in the case of Alberta. The revenue capacity in Column 5 of Table 2-3 is based upon "adjusted own-source" revenues, plus "net" federal-provincial transfers. This revenue capacity is identical to the revenue capacity including total federal-provincial transfers shown in Column 4 of Table 2-1. As was the case with equalization, however, the effects of all federal-provincial transfers are not the same under the two alternative approaches. For those provinces which contribute less to federal financing than expected on the basis of provincial revenue capacity alone, the positive effects of federal-provincial transfers are larger under the "net" approach. The negative effect of these transfers on the resource-rich provinces of Alberta, British Columbia, and Saskatchewan appears to be less under the "net" than under the "gross" approach.

On the other hand, as was the case for equalization alone, Ontario experiences a much greater decline in revenue capacity under the "net" than under the "gross" approach.

The apparent inequities of the current Equalization Program with respect to Ontario, therefore, take on increasing significance when the combined effects of all federal-provincial transfers and their financing are taken into consideration.

Summary and Conclusions

At the beginning of this chapter, we established the importance of the federal Equalization Program both as a source of provincial government revenue and as an expenditure liability of the federal government. The Equalization Program in fiscal year 1980/81 cost the federal Treasury more than $3 billion and accounted for as much as 26 per cent of total revenues in some provinces.

We next traced the origin of the Equalization Program back to the Rowell-Sirois Commission, which outlined a plan for unconditional federal-provincial transfers similar in principle to the Equalization Program. Indeed, the objective of the current program – namely, to make it financially possible for all provinces to provide their residents with "reasonably comparable" levels of services and taxation – was shown to be essentially the same as that embraced by the Rowell-Sirois Commission some 40 years ago.

While the Equalization Program has, in principle, remained largely unchanged since its inception in 1957, it has undergone several significant modifications over the last three decades, the most important of which concerns the comprehensiveness of revenues considered under the equalization formula. The single most significant change to the formula occurred in 1967, when, in an attempt to base equalization on a measure of total provincial revenues, the number of actual revenue sources equalized was increased substantially. While, to a certain extent, the resulting increases in equalization payments were predictable, few could have foreseen what the effect of including 100 per cent of natural resource revenues in the equalization formula was to be on the future growth of the program. Because of escalating world prices for oil and gas and the greater reliance placed on these revenues by provincial governments, equalization payments associated with these revenue sources were driven beyond levels that were acceptable to the federal government.

In response to this situation, the federal government introduced a succession of *ad hoc* changes to the equalization formula between 1974 and 1980, intended to constrain the growth of equalization transfers and aimed specifically at the amount of natural resource revenues that could enter the equalization formula. Even with placing a general limit of 50 per cent on the amount of resource revenues eligible for equalization and with gradually eliminating from the formula all revenues generated from the sale of Crown leases, further steps had to be taken to prevent Ontario from receiving equalization payments in the late 1970s. A series of arbitrary federal amendments thus culminated in what was referred to earlier as the "Ontario Rider" legislation, preventing any province from receiving equalization payments if its per capita income was above the national average for three consecutive years.

The combined effect of the various federal actions to amend the equalization formula since 1974 has been to undermine severely the ability of the Equalization Program to raise the revenue capacities of all provinces, at least up to the national average as determined by a comprehensive representative tax system. This conclusion follows an evaluation of the performance of the program in which the effects of equalization payments were assessed against a comprehensive measure of provincial revenue capacity under two alternative approaches. Specifically, we found that as a result of the program, the revenue capacities of most receiving provinces were brought up to around 82 to 87 per cent of the national average, with those provinces that had the lowest revenue capacities to begin with experiencing the greatest relative increase. The effect of the Equalization Program on some receiving provinces increased when an estimate of the effects of federal financing was taken into account.

In the case of those provinces not receiving equalization payments, the effect of the program, evaluated on either a "gross" or "net" basis, was to reduce revenue capacities. While these declines did not appear to be of great consequence to the "revenue-rich" provinces of Alberta and British Columbia, Ontario's revenue capacity was reduced to below 90 per cent of the national average and, in some cases, below that of some receiving provinces. When the effects of federal financing were taken into account, Ontario suffered a reduction in its revenue capacity in excess of that of the three western provinces. These results have led us to conclude that the Equalization Program is regressive, at least in terms of its impact on Ontario.

The differences in provincial revenue capacities were seen to be much smaller when the effects of all federal-provincial transfers were considered. On

average, the combined effect of these transfers was to raise the revenue capacities of the "have-not" provinces to close to 90 per cent of the national average for all provinces. After taking account of the impact of all federal-provincial transfers, Ontario's revenue capacity was lower than, or equal to, the majority of provinces receiving equalization. Furthermore, when the effects of federal financing are taken into consideration, according to our estimates, Ontario's revenue capacity is reduced considerably more than that of provinces with "above-average" revenue capacity. This result reinforces our concern about the impact of the Equalization Program on the revenue capacity of this province.

3 The Principles of Equalization

While the Equalization Program has become an integral part of the Canadian fabric, which is evident from the widespread agreement that the concept should be entrenched in any new Constitution, there has been little discussion and even less agreement about how such a program can best be shaped to meet its basic objectives. Many observers argue that the mechanisms of the present system of equalization, which were presented in the previous chapter, are no longer adequate (if they ever were).

The problems surrounding the equalization approach are not new; in fact, they have been of concern to economists and policy makers in federal states for many years. Not surprisingly, Canadians have been at the forefront in discussions of these issues. As we have already indicated, the Rowell-Sirois Commission presented, among other things, a blueprint for a set of equalizing intergovernmental transfers. While the outbreak of war interrupted the process of discussion and implementation of these recommendations, the postwar period has witnessed the evolution of a complex set of intergovernmental transfer systems, including the current Equalization Program.

Running parallel to the discussions and decisions of policy makers has been an ongoing discussion among academic economists concerning the economic impact of equalization payments.

While the concept of equalization had first been put forward in 1940 by the Rowell-Sirois Commission as a pragmatic response to the harsh circumstances of the time, it was only in the 1950s and 1960s that economists began to integrate the concept into economic theory. They reasoned that transfers from "richer" to "poorer" provinces were warranted for reasons of distributive justice, or what might be termed "economic equity." In the absence of equalization, residents of richer provinces would be better off than residents of poorer provinces in similar circumstances, which was considered to be unjust. Subsequently, however, the question arose as to whether such transfers would help or hinder the efficient interregional allocation of such mobile factors of production as capital and labour. Would equalization payments tend to cause these inputs to remain in regions where they were less productive than they might be elsewhere or would equalization actually improve the efficiency of the market process?

While these issues were not fully resolved at that time, work by a number of economists in the early 1970s established that there was a broad range of circumstances in which equalization payments were warranted, not only to provide economic justice, but to increase economic efficiency. At the same time, however, it was being argued by other economists that many programs involving income transfers between regions, including certain aspects of unemployment insurance, regional development, and equalization, could provide provincial governments with a "perverse" incentive to engage in policies that, at the very least, would be contrary to the achievement of economic efficiency on a national scale.

The rapid escalation of natural resource prices in the latter half of the 1970s, together with the uneven distribution of such resources across the country, generated a substantial change in the sources of wealth and economic activity in Canada. As a result of the differing fiscal impact of this development among provinces, new questions have been raised about the implications of equalization payments with respect to economic efficiency and equity.

Numerous proposals for reform of the program have since then been advanced in academic and government policy discussions. In light of the broad range of issues raised by these proposals and of the importance of the decisions that must be made in the context of the renewal of current federal-provincial fiscal arrangements, the Council concluded that it was appropriate and timely to undertake a fundamental review of the role played by the Equalization Program in Canadian life.

In particular, our aim is to consider the implications of equalization transfers as they relate to the underlying issues of efficiency and equity in order to lay the

groundwork for devising ways to improve the effectiveness of the program.[1]

After stating what we think the principles of equalization should be, we take a look at alternative proposals for reform of the Equalization Program. We conclude by describing how our proposed program could be applied in practice.

Is an Equalization Program Really Necessary?

In order to undertake a proper evaluation of the role of equalization payments, it is necessary to go back to first principles. We take as given the general political framework of Canada's federal system and the resulting necessity of taking into account the part played in the economy by each level of government. In evaluating the merits of alternate government policies and programs, however, the Council has always taken the view that it is their impact on the well-being of individuals and households that is of ultimate importance. We are interested basically in the economic welfare of people, not of governments. Two of the most important criteria for us have always been efficiency and equity. We are concerned with improving economic efficiency not for its own sake but for the sake of improving the standard of living of all Canadians. Our concern with equity is related to the twin goals of government – namely, the reduction of inequalities in real income between individuals (vertical equity); and the reduction of disparities between provinces in the treatment of persons in similar economic circumstances (horizontal equity). These broad goals seem to have substantial support in Canada – from governments generally and from a number of bodies established to advise them, including the Economic Council.

Given this framework of objectives, a fundamental question arises with respect to the policy best designed to achieve these goals. Why do we need an intergovernmental transfer system when there already exists, at both levels of government, a well-established tax and transfer system for regulating the allocation of economic activity and the distribution of its fruits among persons and households? In other words, what can, or should, be accomplished through a system of intergovernmental transfers that could not be accomplished through the tax and transfer system involving persons? The analysis that follows leads us to the conclusion that there is, in fact, an important role to be played by equalization payments to governments that could not be performed satisfactorily by a system involving personal taxation and transfers. This is the case with respect to the goals of both equity and economic efficiency. The form and amount of equalization called for, however, depend considerably on assumptions about institutional arrangements, as well as underlying economic mechanisms. While the validity of many of these assumptions can be resolved by empirical analysis, at least in principle, some of them hinge on judgments about the constitutional nature of, or ethical grounds for, the allocation of certain property rights in Canada's federal system.

The case in support of an intergovernmental system of equalization rests basically on the fact that the "nominal" or "market" income of Canadians living in different provinces does not reflect the additional benefits and/or costs that result from a myriad of provincial government policies and programs. To a varying extent from province to province, residents are the beneficiaries of goods and services provided by provincial governments or their agencies – for example, highways, health, education, welfare assistance, or subsidized electrical power. By the same token, residents are subject in varying measure to taxation to help cover the cost of providing such public goods and services. As a result of the variation in the impact of these costs and benefits across the country, persons with identical market incomes in different provinces may have quite different "real" incomes after the net impact of provincial government activity is taken into account.

The current system of transfers by governments to persons and families is necessarily based primarily on *market* incomes. It would almost certainly be very difficult to develop a system of personal transfers that would take account of the *real* incomes received by Canadians in every part of Canada. Since equity requires that Canadians in similar personal financial circumstances but living in different parts of the country be in a position to enjoy reasonably similar living standards, it is necessary to have in place an additional mechanism that is capable of reducing differences in the level of goods and services that provincial governments can provide to their citizens at some comparable level of costs. As indicated later in this chapter, such an intergovernmental equalization system is required not only on grounds of equity but also to promote national economic efficiency.

How is a person's real standard of living affected by provincial government activities? As already pointed out, provincial governments provide goods and services to persons and finance these activities by levying taxes. The difference between the benefits a resident receives from provincial activities and the costs he bears can be considered to be his "net fiscal benefit" from the provincial government, which may be positive or negative. For a variety of reasons, it is inconceivable that all residents of all provinces, or of even a single province, will have zero net fiscal

benefits – that is, benefits that are exactly matched by tax costs. It is also unlikely that persons in a given income class will have the same net fiscal benefits regardless of the province in which they live. For example, residents of provinces that are able to raise substantial natural resource revenues will likely have higher net fiscal benefits than residents of resource-poor provinces. The same also applies in provinces that have per capita incomes that are above the national average.

Residents of resource-rich provinces, for example, may receive a higher level of services from their governments at equal or lower cost in terms of taxes than do those in provinces that are less well endowed with resources.

By the same token, the policies adopted by provincial governments for transferring income from upper- to lower-income groups tend to result in the latter having positive net fiscal benefits; the wealthier the province, the higher the net fiscal benefits to lower-income groups.

The Equity Case for Equalization

The total real income of a person (before federal taxes and transfers) in a particular province comprises personal market income from wages and property before provincial taxes, plus the net fiscal benefits derived from provincial government activities.

To provide a basis for understanding the question of equity as it relates to the equalization system, consider first the case in which all provincial residents receive zero net fiscal benefits. In these circumstances, the taxes paid by a person are assumed to be equal to the value of the benefits he receives from provincial government activities. In this case, provincial residents, in effect, receive back in benefits exactly what they pay in taxes, with the result that none experiences either a net increase or decrease as between "market" income and "real" income. In these circumstances, no fiscal benefit is generated. Persons in like positions with respect to market incomes would be treated equally by provincial and federal governments regardless of the province in which they resided. There would be no requirement for any regionally discriminatory fiscal measures such as equalization. Here, both horizontal and vertical equity could be achieved through the personal taxation and transfer system of the federal government.

Now consider the second case – one that mirrors the actual situation that now prevails – in which the net fiscal benefits of most persons within a given province are not zero and there are interprovincial differences in net fiscal benefits between persons in similar financial circumstances. In this case, the requirements of equity would not be met by a federal tax and transfer system based solely on personal market incomes. Horizontal equity would not be achieved because persons with identical real incomes (including net fiscal benefits from provincial budgets) would be treated differently under such a tax and transfer system. Nor would such a tax and transfer system produce vertical equity in the country as a whole. Provincial net fiscal benefits affect the real incomes or living standards of provincial residents (positively or negatively), but that impact is not taken into account by the federal income tax system (or the system of personal transfers). Hence, even if the federal tax system embodied in principle the desired amount of vertical equity, such equity would not be achieved because one important source of personal income is not taken into account by the federal tax system.

What is required to solve these problems is some form of transfer policy that takes account of these differences between provinces. The two main types of instruments that might be considered to achieve this goal are the personal transfer and income tax system and the intergovernmental transfer system.

The personal transfer and income tax system could be adjusted in several ways to achieve the desired goal. For example, each federal taxpayer could be required to adjust his taxable market income by adding or subtracting his amount of provincial net fiscal benefits. Alternatively, the federal tax rate could be adjusted for each province to take account of the effect of net fiscal benefits.

An alternative approach could involve the establishment of a system of intergovernmental grants that would provide transfers to provincial governments, the net value of which would be positive in provinces whose residents have relatively low per capita net fiscal benefits and negative in provinces with high net fiscal benefits. The latter approach, of course, is that embodied in the existing Equalization Program.

But why should it be necessary to supplement the personal tax and transfer system with a system of *intergovernmental* transfers? First, to calculate net fiscal benefits on an individual taxpayer basis would be difficult, costly, and controversial. Second, and more important, to rely solely on a personal transfer system that was adjusted to offset net fiscal benefits would result in the federal government overriding the deliberate redistribution policies and programs of provincial governments. In the Canadian Confederation, federal and provincial governments share responsibility for determining the extent of redistribution of income through the public sector. Any move

by Parliament to nullify the exercise of this responsibility by provincial governments would go a long way towards destroying the nature of the Canadian federal system. We conclude, therefore, that intergovernmental transfers are the *only* acceptable means of remedying the equity problems arising from interprovincial differences in net fiscal benefits. We recognize that some conflict between the redistributive policies of the provinces and that of the federal government is inevitable. The compromise advocated here, and one that is also implicit in the present Equalization Program, is to undertake equalization in such a way as to make it financially *possible* to achieve equity – both vertical and horizontal – for all Canadians, regardless of where they reside. At the same time, the provinces must be permitted to redistribute their own tax revenues as they see fit.

While it would be impractical, as noted earlier, to seek to achieve such redistribution of wealth through personal income tax, it is this basic concept that could underly the development of an analogous system of intergovernmental transfers.

The Broad- and Narrow-Based Views of Equity

Having presented the case for the use of intergovernmental transfers, we now point out that there are two fundamentally different approaches that could be taken to solve these equity problems, each one depending on a different view of horizontal equity. These, we call the "broad-based" and "narrow-based" views of equity. We shall first outline the two views and then present the solutions corresponding to each of them.

The broad-based view calls for the institution of a nationwide fiscal system that is horizontally equitable in terms of the actions of all governments, federal and provincial. According to this view, two persons who are equally well-off *before provincial government actions* must be made so afterwards. To institute a federal tax system that ensures horizontal equity in this sense, the federal government must take account of the nationwide horizontal inequities introduced by the independent behaviour of the provinces by offsetting the actions of provincial governments that result in some persons in certain provinces being better-off than persons in identical circumstances elsewhere.

The narrow-based view is that the federal government should take as a starting point the level of real income attained by persons *after* provincial fiscal systems are in place. In this case, the federal government need only be concerned with ensuring that two people who are equally well-off *after provincial government budgets are in place* ought also to be equally well-off after the federal budget. According to this view, the federal budget need not be concerned with completely offsetting the nationwide horizontal inequities introduced by provincial governments.

One way to regard this distinction is in terms of the property rights or endowments of provincial citizens. Assume that citizens in identical circumstances derive different net real income benefits from provincial economic policies. Then, if one wished to accord full property rights to individuals over such benefits, based solely on their province of residence, the federal government would take as its starting point for establishing horizontal equity the position of citizens after they had received their benefits. This starting point would establish horizontal equity in line with the narrow-based approach. If, however, one did not wish to assign such property rights on the basis of provincial residency, the initial position for horizontal-equity purposes would be that which prevailed in the absence of all government fiscal activity, including that of the provinces. This would be in accord with the broad-based approach. It will be seen that both views call for some sort of equalization on equity grounds, but of widely differing types and amounts.

The broad-based view of equity described above would require that the Equalization Program eliminate all interprovincial differences in aggregate per capita net fiscal benefits. Only when the net fiscal benefits of persons with the same market incomes are fully equalized will like persons (before provincial and federal government action) be treated equally, according to this view of horizontal equity.

The narrow-based solution would turn out to require a much smaller reduction of per capita differences in net fiscal benefits. Since under this narrow-based view of horizontal equity these fiscal benefits are considered part of the incomes of persons before federal taxes and transfers, horizontal inequity arises only if the federal tax and transfer system does not tax this fiscal benefit component of income. Two persons with identical comprehensive income (including provincial net fiscal benefits) will pay different federal taxes if they reside in provinces with different levels of such benefits. Residents of "rich" provinces will pay lower federal taxes than residents of "poor" provinces in identical circumstances. Horizontal equity would be achieved if net provincial fiscal benefits were added to taxable incomes and made subject to federal tax at the marginal rate. Under this approach, the result would be a net transfer from residents of the "richer" provinces to residents of the "poorer" provinces. The same kind of net transfer could be achieved through an equalization program that equalizes only a portion

of the differences in fiscal benefits between provinces, with the proportion being determined by the overall marginal federal tax rate prevailing in each province.

The solution corresponding to each view of horizontal equity can be illustrated with the aid of the following example. Suppose that at a given point in time the real income of a person in Ontario and that of another in Alberta was $10,000 and that subsequently both provincial governments increased the level of services provided to their citizens. Because of the higher level of resource income available in Alberta, the increase in services would be financed entirely from that source, while in Ontario it would be financed from an increase in personal income tax. Assume, for the sake of illustration, that the net fiscal benefit for the person in Ontario as a result of these changes is zero, the extent of the benefit from additional services being offset completely by his increase in taxes. In these circumstances, however, the Alberta resident would experience a net increase in fiscal benefits from the provincial government – of, say, $1,000 – so that his real income would increase to $11,000. To achieve horizontal equity in accordance with the broad-based view, it would be necessary for the federal tax and transfer system to offset completely the differences in real income between the two persons. Under the narrow-based view of horizontal equity, persons in different provinces whose real income was $11,000 would pay identical taxes, but the differences in the net fiscal benefits they received would not be completely offset, as in the broad-based case (differences in net fiscal benefits would be offset only by the amount of federal taxes paid on those benefits).

As noted earlier, the view as to which approach should be adopted with respect to horizontal equity hinges basically on one's conception of how the benefits derived from provincial government actions should be allocated, which in turn raises both ethical and constitutional questions. In our view, there is little justification on ethical grounds for confining such benefits to residents of the particular provinces in which they happen to be located. On the other hand, we recognize that certain rights of ownership were assigned to the provinces constitutionally under the British North America Act. Before considering this issue any further, however, it is necessary to analyse the major factors accounting for differences in net fiscal benefits between provinces.

The Major Sources of Differences in Net Fiscal Benefits

The net fiscal benefits that a resident derives from his provincial government have been defined as the difference between the benefits he receives from provincial expenditures and the taxes he pays. Taxes can be broadly divided into two types: 1/ those levied on the incomes received by the residents of the province, such as personal income tax, which we term residence-based taxes; and 2/ those levied on income or wealth at its source, regardless of the place of residence of the ultimate recipient of the income, such as corporate income taxes, property taxes, and resource taxes, which we term source-based taxes. The analysis that follows considers the implications of each of these categories of taxes with respect to equity and the Equalization Program generally.

Residence-Based Taxes

Suppose that all provincial expenditures were financed by residence-based taxes, such as those on personal income. Then the net fiscal benefit of any person from provincial fiscal activities would be the value of the benefits he derived from provincial expenditures on his behalf, less the provincial taxes on his personal income.

If provincial budgets are distributionally neutral in terms of costs and benefits as between persons, the share of residence-based taxes paid by a person is proportional to the share of the benefits received from provincial government goods and services. Therefore, the real income of a resident of a particular province is simply his personal market income before tax. In these circumstances, no interprovincial differences in net fiscal benefits exist, and there would be no requirement based on equity considerations to equalize differences in residence-based tax collections between provinces.

Now let us move closer to reality by relaxing the assumption that provincial government budgets are neutral in their allocation of costs and benefits as between persons.

In fact, income is redistributed from the more affluent to the less affluent through the interaction of the progressive personal income tax system and a number of provincial expenditure programs for such purposes as health care, education, and social assistance. This progressivity of the provincial budgets has two implications for the real income of a resident of any particular province. First, persons with above-average personal incomes in a province will usually suffer a net loss from this redistributive provincial activity because they contribute more in taxes than the value of goods and services they receive in return from the provincial governments. The opposite is generally true for persons with below-average incomes. Second, persons living in provinces with aggregate per capita incomes above the national

average will receive higher net fiscal benefits from provincial expenditures financed by residence-based taxes.

To illustrate, consider the simple case in which provincial expenditures are distributed among residents on an equal per capita basis, while taxes are proportional to individual incomes. The higher the average income level, the greater the amount of revenue per capita generated by the proportional tax system. Since expenditures are assumed to be distributed on an equal per capita basis, it follows that persons at any given income level will have greater net fiscal benefits on this account in a high-income province than in one with a lower per capita personal income level. In general, the greater the overall progressivity of the provincial fiscal structures, the greater will be the variation in net fiscal benefits between the upper- and lower-income groups in any given province and the greater will be the average difference in per capita net fiscal benefits between high- and low-income provinces.

Since provincial budgets in Canada are generally progressive, the resulting differences in net fiscal benefits give rise to the problems of horizontal and vertical equity described earlier. The nature of the equalization program required to eliminate inequities resulting from residence-based taxes depends on which of the two different concepts of horizontal equity noted earlier is considered valid. If the broad-based view is accepted – that is, that persons have no inherent property rights to higher net fiscal benefits just because they happen to reside in a high-income province – the goal should be to establish an equalization program that would fully eliminate all interprovincial differences in such net fiscal benefits. As already pointed out, the magnitude of the differences arising from residence-based taxes depends on the progressivity of provincial budgets. If the degree of progressivity corresponded to the particular case referred to earlier where taxes were proportional to income and where expenditures were distributed to residents on a per capita basis, horizontal equity would be achieved by equalizing per capita residence-based tax revenue across provinces. The more progressive the provincial tax structure, the greater would be the amount of redistribution of revenue required between provinces.

The narrow-based approach, which is equivalent to treating the net fiscal benefits from these redistributive provincial activities as taxable by the federal government, would require little or no interprovincial equalization of per capita differences in residence-based tax revenues. This is because the positive net fiscal benefits received by those in lower-income groups would cancel out the negative net fiscal benefits received by those in upper-income groups in each province. The total amount of equalization called for in this case would be insignificant.

In our judgment, however, there is little ethical support for the view that residents of a province have some form of property right to the benefits that accrue to them simply by virtue of living in a province with a higher-than-average per capita income. Therefore, we conclude that, in respect of residence-based taxes, considerations of equity require *full* equalization of net fiscal benefits. In the special case described earlier (taxes proportional to income; expenditures distributed equally per capita), this would require complete equalization of per capita residence-based tax collections. For residence-based taxes, at least, this corresponds to the notion that all provinces should have the fiscal capacity to provide similar levels of services at similar rates of taxation.

In reality, however, provinces have different rates of taxation, and any system that equalized the actual per capita revenues collected would act as a major disincentive to the provinces to raise adequate tax revenues on their own, since it would encourage some of them to rely on federal equalization transfer payments. It is far more realistic, in our view, to base equalization on the tax capacities of the provinces. This is determined by their revenue potential resulting from the application of taxation rates based on the average of all provinces. The present Equalization Program would, therefore, seem adequate to achieve fiscal equity with respect to residence-based taxes.

Source-Based Taxes

Source-based taxes, such as those on corporate income, property, or natural resources, are levied by either provincial or local governments regardless of the place of residence of the ultimate owner. Since all provinces have some source-based taxes, the total real income of a person in a particular province consists of his pre-tax personal market income from wages and capital, less provincial taxes on this income, plus the benefits from his share of provincial expenditures financed from the total residence-based taxes *and from the total source-based taxes*. In order to concentrate on the effects of source-based taxes on the real income of persons and the implications with respect to equity goals, let us assume that provincial goods and services financed from residence-based taxes are distributed neutrally – that is, that benefits to persons are matched by tax costs. As already indicated, this implies that there is no need for equalization on account of residence-based taxes. For simplicity, it is also assumed that provincial government expenditures financed from source-

based taxes are distributed on an equal per capita basis.

The simplest case of source-based taxes to consider is that of provincial revenues, often referred to as economic rents, generated from natural resource properties. If these properties are owned by non-residents, the rents collected represent an additional source of income to the province. If property is owned by a provincial government, no rents would accrue to the federal government. If the properties are owned by residents, their property income (and thus the amount of income subject to federal tax) would decline by the amount of source-based taxes collected by the provincial government. In every case, our equity goals would not be achieved, since federal income tax revenue would not adequately reflect the real income available for residents to spend on private goods *or to have spent on their behalf by the provinces*. The differences in the amount of source-based taxes collected across provinces result in interprovincial differences in net provincial fiscal benefits; and, again, some form of equalization is required to correct this situation.

As in the case of residence-based taxes, there are two methods of taking into account the net fiscal benefits derived from source-based taxes in shaping federal redistribution policies, each method corresponding to one of the two views of horizontal equity discussed earlier.

In line with the broad-based view of horizontal equity, the federal tax and transfer system should eliminate all interprovincial differences in net fiscal benefits resulting from provincial government activities. In this case what would be required would be full equalization of all interprovincial differences in per capita source-based taxes, as well as residence-based taxes, to enable a comparable level of provincial goods and services to be provided across the country.

To implement the narrow-based concept of horizontal equity, it would be necessary to take account of the net fiscal position of persons in each province resulting from the benefits financed by the source-based taxes collected by provincial governments. Under this approach, the per capita amount to be transferred would be calculated as the difference between provincial per capita source-based revenue and the national average, multiplied by the overall marginal federal tax rate for that province. Only a portion of the interprovincial differences in net fiscal benefits would be equalized under this approach.

The form of equalization prescribed under the narrow-based view of horizontal equity has merit in that it corresponds to the view that residents of a province really ought to be taken as the proper "owners" of resource rents. It will be preferred to the alternative scheme of full equalization to the extent that one considers it ethically correct, and/or constitutionally necessary, to grant property rights to source-based tax revenues to the residents of the province in which the revenues accrue.

Other solutions between these two extremes are also possible. For instance, it might be decided that it is legitimate (for constitutional reasons) to grant provincial residents property rights to provincial government resource incomes but that it is not ethically defensible to recognize similar property rights to other source-based taxes, such as corporate income taxes and municipal property taxes. Then what would be called for would be partial equalization of the differences in per capita resource revenues (with the proportion determined by marginal federal tax rates) and full equalization of per capita provincial revenues from other source-based taxes, including those local property taxes which are not taken into account by the present equalization formula.

As becomes evident, however, only one of these solutions – full elimination of the differences in net fiscal benefits from provincial public sector activities – is consistent with economic efficiency. Under the other, narrow-based view of property rights, there is conflict between the amount of equalization called for on grounds of equity and that on grounds of economic efficiency.

Before considering efficiency, however, it is necessary to examine some of the other factors that affect the size and distribution of net fiscal benefits and that should be taken into account in the redesign of the Equalization Program.

Other Factors Related to the Size and Interprovincial Distribution of Net Fiscal Benefits

It is desirable to note briefly the effects of certain considerations relevant to the Canadian federal system that have not been dealt with in the discussion up to this point.

First, it has so far been assumed that all tax revenues in a province are used to finance the provision of goods and services for local residents. At least two other alternatives are possible. One is for some expenditures to be used to provide social infrastructure or to cover other costs related to production in the province. To the extent that these expenditures resulted in higher profits or other benefits that would accrue to non-residents, they would not provide net fiscal benefits for domestic

residents and hence should not be subject to equalization. Furthermore, if such expenditures should result in higher wages or other forms of personal income for local residents, they would be reflected accurately in the base of the federal tax and transfer system as personal market income and need not, therefore, be subject to equalization.

Another possibility is that a provincial government might choose to invest a share of its tax revenues (from any source) in a savings fund and then use the interest on this fund to help finance current expenditures. In such a case, it would only be the portion of current tax revenues (plus interest) that is employed to finance current expenditures that would create a current net fiscal benefit for residents of the province; therefore, only this amount should be subject to equalization. For instance, the oil and gas revenues in Alberta that are channeled directly into the province's Heritage Fund should not be subject to equalization; disbursements from the Fund should be subject to equalization.

Second, there are some provincial government activities that result in the creation of net fiscal benefits that are not reflected in provincial revenues but yet should be subject to equalization. An example is the pricing of electricity sold to residents at less than full cost by provincial Crown corporations. This method of distributing rents from electricity creates real income for residents in the same way as would a reduction in tax rates made possible by the profits that would accrue to the government under full-cost pricing. Since this form of real income does not appear in the base of the standard tax and transfer system, it is just like a net fiscal benefit from provincial government activities, and equity considerations require that these rents be taken into account in an equalization program. This last issue has become, and will continue to be, particularly important in current debates over the nature of federal-provincial fiscal arrangements. We shall address it in the following chapter, where estimates will be presented of the size and interprovincial redistribution of natural resource rents in Canada.

Efficiency Arguments for Equalization

To the extent that any factors of production (various types of labour and capital) are mobile between provinces, the achievement of maximum economic efficiency requires that they be allocated in such a way that the productivity of the last such factor transferred be roughly the same in the province to which it has shifted as in the province from which it came (not including moving costs). Where this is not the case, total national production of goods and services could be increased by further reallocations. In other words, if the amount of additional production provided by one of these migrant factors is less in the province of destination than it was in the province of origin, total national production will be less than it would have been had the factor not moved. In terms of national economic efficiency, the migration of factors of production will only be desirable if it leads to an increase in the aggregate production of goods and services.

Can we expect the free interprovincial movement of factors of production in response to market forces to achieve such an efficient allocation? In the event that unequalized differences exist in net fiscal benefits between provinces, the answer is negative. This can be illustrated by considering a particular type of labour, as defined by level of education, skills, and so on.[2] Roughly speaking, workers will move from one province to another if they expect to become better-off by doing so. Aside from the migration costs, the most important factors related to the economic well-being of these workers, as between two provinces, are their personal market incomes and their net benefits from provincial fiscal activities (that is, their share of provincial services, less taxes paid). Since private property income, such as interest, dividends, and capital gains from stock holdings, is generally independent of where a person resides, we can conclude that workers will tend to move from one province to another whenever the sum of expected wages and net fiscal benefits is greater in the province of destination than in the province of origin. There will be a "migration equilibrium" for a particular type of worker only when these sums are similar in all provinces. It follows that if there are any interprovincial differences in net fiscal benefits and labour responds to these differences by migrating, wage rates will also tend to differ between the provinces. Other things being equal, wages will tend to be lower in provinces with high net fiscal benefits because of the influx of workers attracted by those benefits that, in turn, results in a larger supply of manpower in relation to demand. Since workers are generally hired and paid according to their productivity, this means that potential migrants will have different productivities in different provinces. This implies an inefficient allocation of this type of labour between provinces.

What fiscal measures would tend to reduce or eliminate this inefficiency? The solution is an equalization program that would serve to eliminate all interprovincial differences in net fiscal benefits from provincial budgets. In other words, economic efficiency requires that factors of production be guided among activities (including those in different provinces, when this is an option) by signals related to

their productivity in these different locations. Differences in net fiscal benefits between provinces tend to distort the market signals that otherwise would be expected to do this job. The only solution is to eliminate the source of the problem – that is, the differences in net fiscal benefits from provincial government activities. This is true regardless of whether the differences arise from source-based or residence-based tax collections.[3]

The Extent of Fiscally Induced Migration in Practice

It is reasonable to ask whether the concept of "fiscally induced migration" is anything more than a theoretical curiosity. It might be argued that, in practice, most migration of labour takes place in response to the geographic availability of jobs.

Council research on the extent of fiscally induced migration is outlined in Appendix A, where it is shown that for low-income people, in particular, fiscal variables appear to bear roughly the same importance as regional differences in employment and income in explaining the recent trends in interprovincial migration. These findings indicate that the effects of equalization payments and of the differences in provincial government financial capacity arising from natural resource revenues on the movement of labour are significant enough to justify concern about the potential efficiency costs of fiscally induced migration.

Summary Observations on Equity and Efficiency

From the analysis, it is evident that economic efficiency calls for full equalization of interprovincial differences in net fiscal benefits resulting from provincial government activities. Assuming that provincial budgets are of the same degree of progressivity as a system that distributes expenditures on a per capita basis and raises income taxes on a proportional basis, this would require equalization of all interprovincial differences in per capita expenditures financed from all tax sources (again, see note 3 to this chapter).

Under the broad-based view regarding property rights to provincial tax sources – that is, that no one has an inherent right to fiscal benefits that accrue by virtue of residing in a province with above-average tax capacity – the same equalization program is called for on grounds of equity. While we have much sympathy for this view, we also recognize the constitutional powers over natural resources that were granted to the provinces under the BNA Act. These powers might be interpreted as having conferred certain property rights on the residents of any province over that province's natural resources. The implication of this view is that, on equity grounds, provincial expenditures financed by natural resource revenues should be treated differently in an equalization program; only a portion of these revenues should be equalized, with the proportion being determined by the overall marginal federal tax rate on income.

An Evaluation of Alternate Approaches to Equalization

In this section, the "net fiscal benefits" concept is applied to evaluate another approach to equalization that has been proposed, as well as certain alternative proposals for reform of the current Equalization Program that have been put forward.

Replacement of the Equalization Program with a Negative Income Tax Program

Some observers view the Equalization Program as a method of redistributing income from the rich to the poor. It is not a very effective tool for that purpose since it redistributes income between governments rather than persons, and it does not compel provincial governments to behave in such a way as to "improve" the distribution of incomes. In fact, there is the possibility that a program of equalization grants might have the ultimate effect of redistributing income from poor people in Ontario to rich people in Newfoundland. This view often leads to the policy prescription of replacing equalization with a negative income tax or some system of guaranteed annual incomes.

The problem with this proposal is that a negative income tax would still be based on "market" incomes and would not take into account the benefits derived from the fiscal activities of provincial governments. Unless a negative income tax or other such program distinguished between persons in separate provinces on the basis of differences in net fiscal benefits from provincial budgets, horizontal and vertical equity would not be achieved. It is the role of an equalization program to make possible the achievement of these goals.

Recognition, through Equalization, of Interprovincial Differences in the Need, or Cost, of Public Services

While two provinces may have the same revenue-raising capacity, if it costs more per capita to provide

public services (e.g. to build highways) in one province than in the other because of different population sizes or because of differences in real resource costs, it has been argued that there should be some equalization transfer from the low-cost to the high-cost province.

On equity grounds, it is clear that equalization should take account of interprovincial differences in costs, as well as in revenues. The efficiency implications of this argument, however, are not quite so clear. If provincial services are more costly in one province than in another, overall efficiency considerations require that this be taken into account in migration decisions. It is only if the cost differences are based on population size that there might be some argument, on efficiency grounds, for equalization of these differences. Migration confers external benefits on the recipient province (reduced per capita taxes in order to provide the same level of public services) and corresponding costs (increased per capita taxes) on the province that is losing population. The size and direction of the required transfers depend, from an efficiency point of view, on the relative magnitude of these two external factors; they might be quite different from those which would be called for on equity grounds.

Another problem with adjusting for the differences in costs of services is the practical difficulties that would be involved in actually calculating these differences in an acceptable manner.

Equalization and the Differential Treatment of Renewable and Non-Renewable Resources

"Why," it is sometimes asked, "should residents of Alberta provide transfers to the residents of other provinces on the basis of revenues from oil and gas resources that are limited in supply and will soon be depleted?" The answer is quite simple. Equalization should be based on current interprovincial differences in net fiscal benefits. If Alberta's source of above-average net fiscal benefits should disappear sometime in the future and not be replaced by some other source, its residents could well become net recipients of equalization transfers. By the same token, the fact that a province (such as Ontario) has traditionally been a "have" province under the equalization formula is no justification for making arbitrary adjustments in the formula to exclude it when its relative fiscal position begins to deteriorate. The relative fiscal positions of provinces are bound to change over time, and equalization transfers should adjust to take these changes into account.

The Adoption of a General Macro-economic Indicator for Determining Equalization Transfers

It has often been contended that the use of some simple macro-economic measure, such as income per capita in each province, should be substituted for the present representative tax method of determining equalization payments.

The alleged advantages of the simplicity of the macro-economic method may be illusory. At present, the only available macro-economic data (those in the *Provincial Economic Accounts*) are described as "experimental" by Statistics Canada. By way of contrast, the present representative tax method of calculating equalization payments has proved to be relatively straightforward in computation and inexpensive to administer.

There is, however, a more fundamental objection to the proposed use of a macro-economic indicator as the basis for making equalization payments. The efficiency and equity arguments for equalization developed in this chapter are based on interprovincial differences in net fiscal benefits from provincial government budgets. It is highly unlikely that a set of equalization transfers based on any macro-economic indicator would match those considered appropriate on the basis of interprovincial differences in net fiscal benefits. This would be especially true in the case of net fiscal benefits arising from resource revenues.

The Parliamentary Task Force Proposal

The Parliamentary Task Force on Federal-Provincial Fiscal Arrangements recently advanced a proposal for taking account of provincial revenue from natural resources under the Equalization Program. It suggested that for purposes of equalization the amount to be included in the formula should be equal to resource revenues multiplied by *provincial* tax rates. This approach is analogous to a system under which provincial resource revenues would be distributed as private income to residents of each province. In this case, the income would be taxable by provincial governments and would therefore provide net fiscal benefits equal to the resource revenues multiplied by the provincial tax rates.

This proposal would, in effect, apply the broad-based view of horizontal equity, noted earlier, to some hypothetical fiscal benefits from resources. We see no grounds based on equity or efficiency for choosing this method of equalization. In our judgment, it is questionable on two counts. First, we feel that it is the narrow-based view of horizontal equity (based on property rights issues) that is appropriate for equalization of resource revenues in the Canadian

federal system. Second, if an equalization program is to achieve horizontal and vertical equity, it must be based on *actual*, not hypothetical, fiscal benefits created by provincial governments. Thus, instead of applying full equalization to some hypothetical fiscal benefits (as would happen if one were to calculate provincial taxes on resource revenues distributed as income), the analysis developed in this chapter provides strong reasons for applying partial equalization (determined as the overall marginal *federal tax rate* in a province) to actual resource revenues distributed as private income to provincial residents.

Direct Equalization among Provincial Governments

Many proposals for reform of the Equalization Program envisage some form of *direct* participation by provincial governments. Some would have equalization effected exclusively by provincial governments with no participation by the federal government;[4] others suggest that a redistribution of *resource* revenues should take place directly among provincial governments, with equalization of other provincial government revenues being the responsibility, as at present, of the federal government.[5]

There is much to be said for these arguments in principle. In this chapter, the analysis of the rationale for an equalization program does not require the participation of the federal government. Chapter 2 indicated that federal financing of the Equalization Program has led to some problems in terms of the distribution of its costs and benefits. These problems have arisen because the distribution of fiscal capacity among provinces does not match the distribution of federal revenue sources – principally because the federal government has not benefited from resource revenues to the same extent as the western provincial governments.

From a pragmatic point of view, however, the question of direct participation in an equalization program by provincial governments is another matter. During recent intergovernmental discussions, it was unanimously agreed that the Equalization Program should be incorporated in the Constitution and that responsibility for the Equalization Program should continue to be assigned to the federal government. In addition, it can be argued that the problems associated with federal financing of the Equalization Program have been eased by the recent agreements between the oil- and gas-producing provinces and the federal government, which have given the latter much greater access to resource revenues. This point will be developed in subsequent chapters.

Conclusions

There is an important role to be played by interprovincial transfers in the Canadian federal system. We have argued that, in general, there is a strong case for equalization on equity and efficiency grounds.

Some of the principles of equalization developed in this chapter are already incorporated in the existing program. In fact, our analysis has shown that in a federal system such as Canada's, a program of intergovernmental grants based on differing provincial fiscal capacities is the easiest way to attain the objectives of fiscal equity, while also taking into account the discretionary economic policy making of provincial governments. As for the method of calculating equalization payments, the analysis indicates that the present representative tax system is superior to redistribution schemes that would be based on a general macro-economic indicator such as provincial income per capita.

Application of the principles developed in this chapter would lead to some changes in the treatment of revenue sources in the equalization formula. Local government revenues should be fully incorporated into the program. While this is the only modification suggested for the non-resource revenue part of the program, we consider that major changes are called for in the part of the program dealing with resource revenues.

First, we believe that natural resource revenues that are distributed in the form of subsidized prices for government services should be included in the calculation of equalization payments. Second, non-renewable resources should be treated in the same way as renewable resources in the equalization formula. Third, resource revenues should be equalized only when they are distributed to provincial residents. Thus resource revenues *deposited* in heritage funds or other savings funds should not be equalized until they are *disbursed* from those funds in the form of benefits to provincial residents.

There are, however, limits to the extent to which natural resource revenues should be redistributed in an equalization program. The constitutional powers over natural resources that were granted to the provinces in the BNA Act could be interpreted as conferring property rights to the residents of any province over that province's natural resources. Consequently, we have concluded that the amount of provincial resource revenues subject to equalization should be equal to the federal taxes that would be paid if the resource revenues distributed to provincial residents were treated as current income.

Contrary to allegations that the Equalization Program leads to an inefficient allocation of resources in the economy, our analysis has shown that such a program is essential to the efficient functioning of the economy. If factors of production are to be allocated as productively as possible, an equalization program is needed to offset the effects of provincial net fiscal benefits on the movement of such factors. Our research has shown that such fiscally induced migration does take place in Canada, although its extent varies by income group and region.

It needs to be emphasized that efficiency considerations call for complete equalization of net fiscal benefits, including those related to resource revenues, while equity considerations call for something less if we choose to regard Crown-owned natural resources as a provincial property right. Generally, therefore, the issues involved in the equity/efficiency trade-off, as it affects the various Canadian regions, are clearly relevant to the design of federal-provincial fiscal arrangements.

4 The Value of Natural Resources in Canada

Canada is blessed with many valuable natural resources. The massive rise that has taken place in the world price of oil since 1973 has resulted in a correspondingly large increase in the value of Canada's energy-related natural resource production – particularly of petroleum, natural gas, and hydro-electricity. In the case of conventional sources of supply, the cost of producing and transmitting these energy resources to market has risen only moderately in comparison. The effect has been the generation of what are essentially huge unearned gains – a gift of nature – referred to as "economic rent."

In the previous chapter, the case was advanced for an equalization scheme that would provide for some redistribution among the provinces of the economic rents arising from the exploitation of these valuable natural resources on the grounds of both economic efficiency and equity within Canadian Confederation.

The main purpose of this chapter is to demonstrate that economic rent from natural resources has in recent years assumed major proportions in the Canadian economy. To summarize our results, the economic rent from the production of oil, natural gas, and hydro-electricity, together with the relatively minor provincial government revenues from forestry and mineral production, is conservatively estimated to have been in the order of $29 billion in 1980, or about 10 per cent of the gross national product in that year. This is twice the percentage of gross national product that these economic rents represented only two years earlier. In 1980, such rents amounted to around $4,800 for a family of four.

A second objective of this chapter is to present estimates of the extent to which the economic rent from these resources has been redistributed from the provinces in which production occurs to other provinces in recent years. In total, the net amount of income gained by the seven provinces that were net beneficiaries of this redistribution is estimated to have been about $13.5 billion in 1980. This is more than the approximately $12.3 billion in cash transfers from the federal government to all the provincial governments in fiscal year 1980/81.

The redistribution of the economic rent from these natural resources has taken place through four major types of government involvement: energy pricing policy, taxation policy, natural resource development contracts, and the Equalization Program. For the most part, the amounts of income redistributed through these mechanisms cannot be gleaned from conventional economic statistics; in other words, these transfers have been mostly implicit. The amounts redistributed explicitly through the Equalization Program have been relatively small in comparison with the total amounts transferred among the provinces in 1980.

The Concept of Economic Rent

The development of the concept of economic rent is most closely associated with the name of the noted economist David Ricardo[1] although it has also been investigated by many other economists. Over the years, the concept has been clarified, but disagreements with regard to the measurement of economic rent still exist.

Simply defined, pure economic rent is the income accruing to a factor of production, the total supply of which is fixed. As a result, an increase in the demand for a particular factor from a particular source, employing a given technology, can only increase the price paid for it. The increased demand cannot cause more of the limited factor to be created, although additional sources may become available at higher prices with the application of different technologies. Broadly defined, according to another noted economist, "the essence of the conception of rent is the conception of a surplus earned by a particular part of a factor of production over and above the minimum earnings necessary to induce it to do its work."[2]

In the case of a particular natural resource, economic rent on current production arises to the extent that the competitive market price for the resource exceeds the least-cost method of exploiting it. The cost of production must allow for the minimum payments – the so-called "opportunity cost" – for

the labour and capital required before production can take place.

Because natural resources in different locations differ in quality, in accessibility to market, and in costs of exploitation, the costs of producing them differ. The economic rent, therefore, will generally not be the same on all sources of a given natural resource. The competitive market price must rise to a level that is just sufficient to cover the cost of production of the marginal source needed to satisfy market demand. The marginal source will, therefore, earn no economic rent. In the case of lower-cost sources, there will be economic rent equal to the difference between the competitive market value and the cost of production.

The economic rent generated from conventional oil and gas production in Canada has increased tremendously in recent years because of the rise in world prices, attributable to the activities of the OPEC cartel, and because of the growth of world demand in relation to the international stock of conventional oil and gas reserves that is available. The depletion of existing domestic reserves, together with the rise in the world price of alternative supplies from abroad, has made it necessary to bring new marginal oil and gas resources into production to satisfy domestic demand. The long-run cost of bringing these additional domestic supplies on stream, of importing these resources from abroad, and of developing substitute forms of energy are far in excess of the cost of exploiting conventional reserves. Hence the domestic prices of oil and gas must rise well above the cost of exploiting conventional reserves if the marginal sources of supply are to be brought on stream. Similarly, the economic rent arising from the production of electricity from many of the existing sources of hydro power has also risen. This is because the costs of bringing additional sources of hydro-electric power or alternative energy technologies into production to meet the future demand for electricity are in excess of the costs of production from existing hydro sites.

There are, of course, economic rents generated from the production of other natural resources in Canada. The forestry resources in British Columbia, the production of wheat in Saskatchewan, and the metallic and (non-energy) non-metallic minerals in several of the provinces are some notable examples. A study prepared several years ago for the Economic Council by Lawrence Copithorne provided some crude estimates of the amount of economic rent generated, by province, from the production of various natural resources in Canada in the early 1970s.[3] It can be inferred from that study [p. 78] that even before the rapid rise in the price of oil, the rent on oil and gas production in Canada was about equal to the combined rents from agriculture, forestry, fishing, and other minerals.

It may be argued that the measures of economic rent, or windfall gains, on natural resource production developed in this chapter overlook the fact that there are other forms of economic rent that may be important in Canada's non-resource industries – in the manufacturing sectors of Ontario and Quebec, for example. Industries that are well located may earn location rents, and factors of production operating behind tariff and non-tariff barriers may also earn differential rents – surpluses beyond what they could earn if the barriers were not there. We shall not delve into measures of those kinds of rent in this chapter. In the Copithorne study, however, some very rough calculations were made of the windfall for manufacturing. It was indeed found [also on p. 78] that there were large rents generated in manufacturing in Ontario and Quebec, rents that were much larger than the windfalls calculated for natural resources in the early 1970s. Since then, however, natural resource rents have increased dramatically, while the fortunes of manufacturing in Ontario and Quebec have probably not improved. Thus the presence of other forms of economic rent in Canada is not disputed. The aim of this chapter, however, is to document the size of natural resource rents and ascertain how they have been shared nationally. Our inquiries into the economic rationale for the Equalization Program in the previous chapter suggested that it is the rents collected or redistributed by governments or their agencies, such as oil royalties and hydro rents, that pose problems in attaining the goals of equity and efficiency in Confederation. Rents not collected or redistributed by government will generally be reflected in the tax bases of the regional and federal governments and need not affect the attainment of equity and efficiency.

The Estimation of Natural Resource Rents

In recent years, the major source of economic rent from natural resource production in Canada has been the energy sector – from conventional oil, natural gas and liquefied petroleum gases (LPG), and hydro-generated electricity. While these resources have thus been the primary focus of our efforts to estimate the magnitude of natural resource rent in Canada, a first approximation of economic rent generated by forestry and (non-energy) mineral production has also been incorporated into the analysis (see Appendix Table B-1). These estimates include only the provincial government revenues from these latter two resources and can be considered low estimates of

economic rent, as in all likelihood some of the windfall gains are retained by the producers. In addition, no attempt has been made to calculate the extent of rents in agriculture or fisheries, but they are likely relatively small.

As will be indicated in the discussion to follow, our estimates of economic rent from oil, gas, and hydro-electricity production are also first approximations, which are almost certainly on the low side of actual rent. Greater precision would require a much more intensive analytical study than the Council has been able to undertake at this time.

Economic Rent from Oil and Natural Gas Production

The economic rent from oil and natural gas production is estimated in two parts: the first is the rent generated up to the domestic wellhead prices; the second is the amount accounted for by the difference between the domestic wellhead prices and the relevant external market price.

For the first part, provincial government royalties from oil and gas production, revenues from the sale of Crown leases, and other relatively minor revenues have been taken as the amount of economic rent (see Appendix Table B-1). There are two major shortcomings to this approach. The first is that the revenues from the sale of Crown leases represent a portion of the economic rent anticipated on future production from the leased sites, not on current production.[4] The second major shortcoming is that this estimate does not include the amount of rent that has undoubtedly been captured by the producers.[5]

The estimation of oil and gas rent accounted for by the difference between the domestic wellhead prices and the relevant external market price is also derived in several parts, depending on the fuel and the market served. In the case of crude oil exported to the United States, this part of the economic rent has been assumed to be equal to the amount of the federal export charges.[6]

In the case of domestic production of the crude oil serving the domestic market, two estimates have been made of the rent generated beyond the wellhead price. A high estimate is derived, based on the export charge rate for light and medium oil, and oil condensates (reflecting what producers could receive in the U.S. market), and a low estimate is based on the federal import compensation rate at Toronto/Montreal (reflecting what Canadian consumers would have had to pay, on average, to purchase foreign crude).[7]

Until the National Energy Program was initiated, there was no federal tax on the export of natural gas.[8] The producing provinces, therefore, received the full value for their exported natural gas and liquefied petroleum gases. Ignoring any rent obtained by the producers, the royalties received by the producing provinces would reflect this market value; thus no further adjustment has been made for the rent on these exports, as was made in the case of oil exports.

In the case of domestically produced natural gas and liquefied petroleum gases consumed in Canada, however, wellhead prices have also been held below world levels in terms of their energy equivalent of oil. High and low estimates have been developed with respect to the economic rent generated for these fuels beyond the wellhead price. The high estimate is based on the full amount of the energy-equivalent price of imported crude oil; the low estimate is derived by using 85 per cent of the energy-equivalent price of imported crude oil at Toronto/Montreal.

Based on the above procedures, the economic rent from the production of oil and of natural gas and liquefied petroleum gases in Canada is estimated to have been between $21.7 billion and $26.2 billion in 1980 (see Appendix Tables B-1 through B-3 for details of the estimates).

Economic Rent from Hydro-Electricity Production

The price paid for electric power by most Canadian consumers, particularly those being supplied by public utilities with substantial hydro-electric generating capacity, is exceptionally low in relative terms. This results from three main factors.

First, most utilities in Canada have not been imposing sufficient charges on the electricity they sell to earn a reasonable (social opportunity cost) rate of return on the replacement value of the capital they have invested. It has been estimated in one recent analysis that in order to earn such a rate of return, it would be necessary for public utilities in Canada to increase electricity rates by an average of about 68 per cent.[9]

Second, above and beyond earning such a rate of return, neither the public utilities nor provincial governments have been collecting most of the economic rent generated by the use of hydro resources. These resources generate economic rent because the cost of producing electricity, after allowing for an adequate rate of return on the replacement value of the capital invested, is less than the cost of developing new hydro sites or of producing electricity using the least-cost alternative technologies. The economic rent from these resources

has, for the most part, been passed on to consumers as a subsidy through low prices.

Third, the price of electricity is low to the extent that it is produced by thermal generation, fired by oil or gas, which are themselves subsidized.

It is more complex to estimate the economic rent from hydro-produced electricity than to estimate that from oil and gas. Utilities produce electricity using various technologies such as gas turbines and hydro, nuclear, coal, and oil-fired stations in a highly integrated and interdependent manner. It is difficult, therefore, to measure the economic rent from hydro generation without considering the system as a whole. A special study was undertaken for the Economic Council to estimate the economic rent on hydro resources used by the electric utilities in four provinces: Quebec (including Churchill Falls), Ontario, Manitoba, and British Columbia.[10] In 1979, the hydro resources used by the utilities in these four provinces accounted for about 93 per cent of the hydro-electricity generated by all electric utilities in Canada.

The method used to estimate hydro rent in this study was to compare the cost of the current system as a whole with that of the least expensive alternative available to meet the demand without resorting to hydro power. The difference between the costs of the two systems in a given year was then taken to be an estimate of the hydro rent – that is, the cost savings made possible by the availability of hydro.

In order to undertake a proper comparison for the purpose of measuring economic rent, the study compared the economic costs of the two systems, as opposed to the costs recorded in financial accounts. Among a number of adjustments was the provision for a normal rate of return on capital and payment of the world price for fuels.

These results should not be taken as extremely precise estimates. Since the hydro rent is derived as a residual, the estimates of economic rent will be quite sensitive to errors in estimating the economic costs of the current system and the least-cost alternative system.[11] The sensitivity of the rent estimate will be particularly great where the difference in the economic cost of the two systems is relatively small.[12] Where precise information was not available, however, assumptions were made that would tend to reduce the measures of hydro rent, with the result that the estimates are conservative.[13]

Based on the preliminary results of this study, the economic rents estimated to have been derived from the production of hydro-electricity in 1979 by the utilities in the four provinces are as follows: Quebec, $1.9 billion (of which $548 million is calculated to have been accounted for by Churchill Falls); Ontario, $690 million; Manitoba, $414 million; British Columbia, $127 million.[14] Extending these calculations to the other provinces leads to an estimate of the economic rent from hydro-electricity produced by all utilities in Canada of about $3.4 billion in 1979, of which $3.1 billion comes from the four provinces listed above. As an estimate of economic rent on hydro-generated electricity, this is almost certainly on the low side, given the conservative estimating procedures applied and the fact that, in 1979, industrial establishments, as opposed to utilities, generated about 11 per cent of the hydro-electricity in Canada (primarily for their own use, but also for distribution to other consumers).

In order to incorporate the hydro rents for 1979 into our estimates of economic rent from oil, gas, forestry, and minerals for 1980, we have simply increased the former by 10 per cent to take the general rate of inflation into account (see Appendix Table B-2).

The Interprovincial Redistribution of Economic Rent

Having arrived at a rough estimate of the amount of economic rent generated by oil, gas, hydro-electricity, forestry, and mineral production in 1980, this section considers how, and to what extent, these rents have been redistributed from the producing provinces to other provinces. This redistribution has taken place mainly through four types of government action: underpricing, taxation, resource contracts, and the Equalization Program.

Crude Oil Rents Not Collected by Provincial Governments

The major mechanism by which rents on crude oil that are not collected by the producing provinces are redistributed is through the policy of pricing domestically produced oil below the world price. The value of this windfall gain to consumers has been estimated, based on the compensation rate on imported crude oil landed at Toronto/Montreal – that is, the difference between the price of imported oil and the delivered price of domestically produced crude.

In order to determine the net amount of redistribution, however, it is necessary to take account of how the economic rent that is passed on to consumers in the form of a price subsidy is financed. By far the most important means by which these subsidies have been underwritten is through the rents that the producing provinces have been required to forgo as a result of the federal policy of maintaining the wellhead price of oil, both for domestic consumption and for export, significantly below world price levels. As

noted, high and low estimates of these forgone revenues have been made.[15]

The extent of the subsidy to consumers has been offset by a number of federal consumption taxes. Beginning in 1975, for example, the federal government imposed a tax of 10 cents per gallon on motor gasoline for personal use. This tax was subsequently reduced to 7 cents per gallon in September 1978. Over the period from 1976 to 1980, the federal government also imposed a levy of varying amounts on all refined petroleum products consumed in Canada, in order to provide a return to producers of synthetic crude that was equivalent to prevailing world prices – the so-called "Syncrude Levy."[16]

As part of the National Energy Program, the federal government began levying a petroleum compensation charge of $2.55 per barrel on all domestic refiners, beginning on November 1, 1980. Of this amount, $1.75 covered the then-prevailing Syncrude levy, which was rolled into the petroleum compensation charge, and the remaining 80 cents was imposed to cover a portion of the cost of oil import compensation payments made by the federal government. It has been assumed that all of the federal taxes listed above were paid within each province in proportion to the amount of relevant petroleum products consumed.[17]

The net redistribution of rents for each province is calculated as the amount of the price subsidy to consumers, less the province's contribution to financing as a result of rent not received from production and the payment of federal levies by consumers. As shown in Appendix Table B-5, this is recorded as a net gain if positive and a net loss if negative. (Since the total amount of the subsidy and the total amount of financing through these various mechanisms are not necessarily equal to each other, any difference has been accounted for by adjusting proportionately the contribution made by each province to federal general revenues.)

Natural Gas and Liquefied Petroleum Gas Rents Not Collected by Provincial Governments

As in the case of crude oil, the low domestic price established for natural gas is the major means by which rents not collected by producing provinces are passed on to consumers. High and low estimates of the value of the subsidy have been made, using the alternative approaches previously described. As in the case of oil, the major means by which this subsidy is financed is also through rents that the producing provinces have been required to forgo because of the price ceilings established by the federal government. Beginning on November 1, 1980, the subsidy was offset to the extent of a new federal levy of 30 cents per 1,000 cubic feet on natural gas and its LPG equivalent, consumed domestically. The net redistribution of rents in the case of gas is calculated in the same way as for oil (see Appendix Table B-6).

Hydro-Electricity Rents Not Collected by Provincial Governments

Because Canada is a net exporter of electricity, some of the rents that are not collected by the provinces or utilities because of the low charges they impose are passed on as benefits to consumers in the United States. Because of transfers of electricity between the provinces, it is conceptually difficult to identify the ultimate source of the energy exported. Nevertheless, an attempt has been made to allocate this production and to calculate the rent lost on exports by each of the provinces. The remainder of the economic rent is passed on to Canadian consumers of electricity. In most cases, the net exports of electrical energy to other provinces is not large in relation to production in any of the provinces, with the result that the interprovincial transfer of economic rent on hydro-electricity is not very great in relation to the rent passed on to provincial consumers. The major exception is the sale by the Newfoundland government, under a long-term contract, of a substantial block of power from Churchill Falls to Quebec at a price far below its opportunity cost. The net effect of this is a transfer of the economic rent from the producing province, Newfoundland, to consumers in Canada – primarily those in Quebec – and to consumers in the United States.

In order to calculate the amount of rent from hydro-electricity production lost on exports and transferred among the provinces in 1980, we have derived estimates for 1979, based on the rent estimates and the quantities of electricity sold to the United States and to other provinces in that year, and have increased the figures by 10 per cent across the board (see Appendix Table B-7).

Equalization of Natural Resource Revenues

Because a portion of provincial government revenues from natural resources is included for purposes of calculating payments by the federal government under the Equalization Program, there is a resulting transfer of funds among provinces. The *gross* transfer represents the additional amount of equalization that is paid out to qualifying provinces by the federal government as a result of the partial inclusion of these resource revenues in the formula. To arrive at an estimate of the *net* transfer, however, it is necessary to deduct the amount paid by federal

taxpayers in each province to cover the cost of the equalization payments resulting from the inclusion of resource revenues in the equalization formula. This has been allocated in proportion to the total amount of federal taxes collected from each province. It is important to note that this redistribution of federal funds resulting from the inclusion of a portion of provincial resource revenues in equalization does not represent a transfer of these particular resource revenues among the provinces. In fact, the largest proportion of this cost is borne by federal taxpayers in Ontario (see Appendix Table B-8).

The Provincial Distribution of Economic Rent in Canada

Table 4-1 below provides estimates for 1980 of: the total amount of economic rent in each province from the production of selected natural resources, particularly oil, gas, and hydro-electricity production; the rent on hydro-electricity lost on exports; the redistribution of these rents among provinces as a result of the impact of government policies, including the Equalization Program; and the net distribution of the rent to each province as a result of this process of redistribution. For the sake of simplicity, the high and low estimates of rents outlined earlier for oil and gas have been averaged out in Table 4-1, but the detailed figures can be found in Appendix Tables B-1 through B-9.

What the statistics indicate may best be explained by taking the case of a single province. Table 4-1 shows, for example, that in 1980 Saskatchewan received natural resource revenues of about $695 million, which is taken to represent the economic rents that it collected. Further rents were available but uncollected on oil, gas, and electricity, totalling some $1.5 billion, with the result that total rents produced in the province amounted to around $2.2

Table 4-1

Estimates[1] of the Magnitude and Distribution of Natural Resource Rents, Canada, by Province or Territory, 1980

	New-foundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
						(Millions of current dollars)						
Provincial natural resource revenues (excl. water power rentals)	27.9	0.2	9.8	13.4	114.1	138.4	43.2	695.2	5,089.3	874.7	-	7,006.4
Rents not collected on:												
Crude oil	-	-	-	-	-	13.8	83.3	1,296.3	10,305.9	315.8	23.5	12,038.6
Natural gas and LPG	-	-	-	0.3	-	45.3	-	183.6	5,242.8	521.7	54.9	6,048.5
Hydro-electricity	736.7	-	26.4	70.5	1,514.4	758.1	455.8	29.0	6.7	139.7	-	3,737.3
Total rents, by province of production	764.7	0.2	36.3	84.2	1,628.5	955.6	582.3	2,204.1	20,644.6	1,851.9	78.4	28,830.8
Hydro rents lost on exports	-73.5	-	-0.1	-9.1	-175.0	-92.4	-55.6	-0.1	-	-6.3	-	-412.1
Redistribution to other provinces of rents not collected on:												
Crude oil	305.5	58.6	683.7	659.3	3,320.4	3,761.0	302.4	-831.5	-9,194.4	892.3	42.8	-
Natural gas and LPG	1.6	0.4	4.5	3.1	387.7	2,407.4	279.3	269.7	-3,408.3	80.0	-25.4	-
Hydro-electricity	-529.6	3.4	3.9	71.3	334.7	162.2	-76.4	30.5	0.4	-0.4	-	-
Redistribution of natural resource revenues to other provinces through equalization	27.6	15.2	83.9	54.2	502.2	-431.0	84.1	-103.6	-114.2	-114.3	-4.0	-
Total redistribution of rents to other provinces	-194.9	77.6	776.0	787.9	4,544.9	5,899.6	589.4	-635.0	-12,716.5	857.5	13.4	-
Net distribution of rents	496.2	77.8	812.1	862.9	5,998.4	6,762.9	1,116.1	1,569.0	7,928.1	2,703.2	91.8	28,418.6
						(Dollars per capita)						
Resource rents, by province of production	1,318.6	1.9	42.5	119.0	258.4	111.5	586.2	2,274.1	9,932.5	702.4	1,217.5	1,205.6
Redistribution of rents to other provinces	-336.1	624.1	910.2	1,114.3	721.0	688.4	573.2	-655.2	-6,118.1	325.3	208.5	-
Net distributed rents	855.7	626.0	952.7	1,220.4	951.6	789.1	1,085.3	1,618.9	3,814.4	1,025.3	1,426.0	1,188.3

LPG – liquefied petroleum gases.
1 Average of the high and low estimates in Appendix B.
SOURCE Estimates by the Economic Council of Canada.

billion, as shown on line 3. In the case of Saskatchewan, only a small amount of rent on hydro was lost to U.S. consumers. As a result of the redistribution of rents on oil to other provinces and the impact on the province of the cost of financing equalization payments arising from resource revenues, Saskatchewan suffered a significant loss of $935 million to other provinces. This was only partially offset by a gain of $300 million from other provinces on gas and electricity consumed. The result, shown on line 7, was a net redistribution of rents and equalization costs to other provinces that amounted to $635 million. The net effect of these transfers was that Saskatchewan retained $1.57 billion, or about 71 per cent, of the total rents produced in the province ($2.2 billion) in 1980. On a per capita basis, the rents available from resources produced in the province that year amounted to $2,274; but after redistribution to the other provinces of $655 per capita, the net rent retained in Saskatchewan per person was $l,619.

The first and foremost point that emerges from the figures shown in Table 4-1 is the magnitude of the total amount of economic rent generated in Canada in 1980 – namely, some $28.8 billion. This can be considered a conservative estimate of economic rent on natural resource production in that year. It was almost two-and-a-half times as great as the amount of rent estimated on a comparable basis in 1978 ($11.6 billion) – an increase that resulted primarily from the approximate doubling of the world price of oil between these two years. In 1980, these natural resource rents were equivalent to around 10 per cent of the gross national product, twice the percentage in 1978.

The redistribution of these rents, as between the provinces, also illustrates an important point about the nature of the Canadian Confederation. If Canada were a unitary state and if natural resources were publicly owned, all of the rents would go to the central government and would be available for distribution in line with its priorities. In 1980, that would have amounted to a sum of around $1,200 for every Canadian. If the view had prevailed that provincial governments were entitled to most, if not all, of the economic rents flowing from their ownership of natural resources, then presumably virtually all of the rents would have been retained within the producing provinces and would not have been available for redistribution for the benefit of Canadians generally. In 1980, the effect of the various policies, programs, and agreements in place resulted in the fact that of the total estimated economic rents of $28.8 billion, nearly half (some $13.5 billion) was redistributed on a net basis from three provinces to the remaining seven.

The major source of economic rents from natural resources, including both those collected by the provinces and those passed on to consumers, was oil and gas production. In 1980, oil and gas rents, combined, amounted to around $24 billion (of which about $8 billion was generated from natural gas and LPG production), and they represented about 83 per cent of the estimated total rent. As noted, these figures do not include the rent that was likely captured by oil and gas producers. Economic rent arising from hydro-electric production was estimated very conservatively to be in the order of $3.7 billion in 1980, or about 15 per cent of oil and gas rent (and close to 50 per cent of rent on gas alone).

Of the total estimated rent in Canada for 1980, nearly 72 per cent ($20.6 billion) originated in Alberta. Of that amount, however, some $12.7 billion (more than 60 per cent) in rents and financing costs for equalization based on resources were redistributed to other provinces, with the result that Alberta's net rent was reduced to $7.9 billion. On a per capita basis, Alberta's resource rents amounted to $9,932, of which $6,118 was redistributed to other provinces, leaving a benefit for individual Albertans of $3,814. Notwithstanding the very large redistribution, the remaining net benefit per capita in Alberta was more than three times as great as the average for the nation and more than twice as great as that of any other province. It compares, for example, with net benefits in Saskatchewan, the next highest province, of $1,619; with $789 in Ontario; and with $626 in Prince Edward Island, the lowest on the ladder.

Total economic rent produced from resources in Newfoundland in 1980 amounted to around $765 million (about $1,318 per capita), with the bulk of this amount (about $737 million) being generated from hydro-electricity. Most of this rent (or an estimated $600 million) was lost to consumers in the United States and elsewhere in Canada as a result of the sale of a large quantity of electricity from Churchill Falls to Quebec at exceptionally low prices under a long-term contract. As a result of gains in economic rent, mainly from the consumption of oil, the net distribution of rent to Newfoundland amounted to $496 million, or about 65 per cent of the total estimated rent generated in the province.

A point that bears repeating is that the amount of net redistribution that occurs as a result of the inclusion of natural resources in the equalization formula is of minor significance – after account is taken of the cost of financing this additional payment by the federal government – compared with the implicit redistribution through other mechanisms. For example, of the $12.7 billion that was redistributed from Alberta to other provinces, only $114 million

was accounted for by its resource-related contribution to the Equalization Program. In the case of Newfoundland, a net loss of about $296 million in economic rent in 1980 was replaced by a net gain of only $28 million from the equalization of resource revenues.

The greatest impact of the equalization of resource revenues was felt by federal taxpayers in Ontario, who paid out $431 million to cover the lion's share of the cost. Despite the impact, however, Ontario was the largest single beneficiary of the redistribution of resource rents, receiving a net total of $5.9 billion from other provinces in 1980, after taking the cost of equalization into account. While the amount of rents estimated to be generated from resources in Ontario amounted to only $956 million, the net rents that the province derived after redistribution came close to $6.8 billion, or $789 on a per capita basis.

It is difficult to assess the net provincial distribution of these rents without having some "ideal" standard with which to compare the outcome. While the redistribution is generally in the direction of greater equality, there are several anomalies suggested by the results of the estimates for 1980.

Alberta, which had more than eight times the national average rents per capita at the point of production, had only a little more than three times the national average after redistribution. Saskatchewan, with rents 89 per cent higher than the national average per capita at the point of production had rents about 36 per cent higher after redistribution. In contrast, Newfoundland, with rents per capita about 10 per cent higher than the national average at the point of production – and the only other province besides Alberta and Saskatchewan with rents above the national average per capita – stood at around 72 per cent of the national average after redistribution, the third lowest of all the provinces.

While per capita rents originating in Prince Edward Island, Nova Scotia, and New Brunswick differed only slightly in absolute terms, the disparities after redistribution were much greater, varying from about 53 per cent of the national average per capita in Prince Edward Island to about 80 per cent in Nova Scotia and 103 per cent in New Brunswick. Prince Edward Island, the poorest province, had the lowest rent per capita after redistribution.

Conclusions

Taking into account mainly the economic rents from crude oil, natural gas, and hydro-electricity production, together with the much smaller provincial government revenues from forestry and other mineral resources, economic rent has come to assume major proportions in Canada, amounting to at least 10 per cent of gross national product in 1980. While we have sought to indicate how these large gains were, in fact, distributed that year, the nature of this distribution will change in the coming years, particularly as a result of the recent energy agreements between the federal government and the governments of the oil- and gas-producing provinces. We are left, however, with troubling questions about how these large rents should be allocated in future, in order to best attain the goals of equity and economic efficiency in the nation as a whole.

5 From Principles to Practice: Reforming Equalization

In Chapter 2, we noted that the traditional and current objective of the Equalization Program was, and is, to enable all provinces "to provide a reasonably comparable level of basic services, without resorting to unduly burdensome levels of taxation." In practice, as also noted, the program has been designed to raise the financial capacity of "have-not" provinces in relation to some measure of average financial capacity in all provinces. It was our assessment, indeed, that this was the only practical way to implement the stated objective of the program without having it biased towards either tax relief or public expenditures. The neutrality of the program in this respect was seen to be a desirable feature.

It was pointed out that, as originally proposed by the Rowell-Sirois Commission, the program was intended to reflect differences in the levels of service and tax burdens established by provincial *and local* governments. The only local government taxes that are equalized in the present equalization formula, however, are school taxes; most local government revenues are not equalized.

It was also shown in Chapter 2 that the objective of the program had evolved by 1967 to include equalization of *all* provincial revenues to the national average per capita level. The pressures on the federal government in the 1970s to increase equalization outlays as a result of the rise in provincial natural resource revenues, however, led it to retreat from the objective of equalization of all provincial government revenues. Several types of restrictions have been imposed on the program. In the first place, some resource revenues are counted in full; only half of other resource revenues are equalized; and some are totally excluded. Under the present equalization formula, moreover, above and beyond these restrictions, a ceiling has been placed on the extent to which total equalization payments are determined by all provincial natural resource revenues (referred to hereafter as the one-third constraint or "cap"). As an additional cost-saving measure, it was also decided by the federal government that no province whose per capita income exceeded the national average for the current and two preceding years could qualify for equalization payments. This "personal income override" provision was clearly intended to prevent Ontario from qualifying for equalization payments to which it would otherwise have been entitled.

Federal difficulties in financing the Equalization Program, and the measures undertaken to cope with these difficulties, have had some unfortunate distributional consequences, particularly for the province of Ontario. The Equalization Program, in effect, transfers resources from Ontario to provinces that traditionally receive equalization payments in response to the rise in resource revenues in the western provinces. We have estimated that, in the absence of the burden of financing the Equalization Program and other federal-provincial transfers, the per capita financial capacity of Ontario would be at, or slightly below, the national average for all provinces. The effect of the Equalization Program, however, has been to reduce the per capita financial capacity of Ontario to well below the national average for all provinces and even below the per capita financial capacity of some of the provinces that are receiving equalization payments.

The problems of the Equalization Program have led to many proposals for its reform. Indeed, the fundamental objective of the program has been attacked. Some have argued that the program should be replaced by a guaranteed annual income program directed towards people; others have argued that the program has adverse effects on the efficiency with which resources are allocated in our economy. There is clearly no agreement at present on the underlying philosophy of the program.

It was against this background that the Council undertook a fundamental evaluation of the principles of equalization. This evaluation found that an equalization program is indeed necessary to attain the goals of both efficiency and equity in Canada. Achievement of economic efficiency for the nation as a whole would require full equalization of the per capita financial capacity of provincial and local governments. On the other hand, the attainment of

equity goals would only require equalization of a fraction of natural resource revenues if provincial property rights to natural resources were recognized. That fraction would be determined by the federal tax rate that would apply to those revenues if they were distributed as income to provincial residents.

This analysis leads to some practical principles for reform of the Equalization Program. It suggests, for example, that all provinces should be eligible to receive equalization payments based on their financial capacities and that the present "override" with respect to personal income levels should be abolished. It also suggests that local government taxation – as well as provincial government revenues – should be equalized.

Furthermore, it suggests that, unlike in the present program, there could be rational principles behind the treatment of resource revenues in an equalization program. These principles show that resource revenues distributed by provincial governments to their residents in the form of subsidies for goods and services should be included in the equalization formula. When these resource revenues are deposited in savings funds, such as the Alberta Heritage Fund, however, they should be excluded from the program and from the formula. Taking these principles into account, a fraction of the resource revenues would be equalized, with this fraction determined according to the federal tax rate applicable to the resource revenues distributed as income to provincial residents. On the basis of these principles, then, there is no longer need for different rules to be applied to the various resource revenue sources. Resource revenues can be treated uniformly in an equalization program.

In putting forward these principles as a basis for public discussion, the Council recognizes that not all can, or should, be implemented immediately. In particular, the principles suggested as a basis for equalization of natural resource revenues cannot, and should not, be adopted without extensive public and intergovernmental discussion. Pending the development of a possible consensus in support of such an approach, the Council suggests that any interim arrangements for the Equalization Program should not impede movement towards a program based on some logical and consistent principles. In this respect, the Council notes that the long-run principles derived from its analysis suggest that equalization outlays arising from natural resource revenues should not increase in real terms under any interim arrangements established with respect to this part of the program.

Simulations of Changes in the Equalization Program

The purpose of the remainder of this chapter is to indicate the financial implications of possible changes in the Equalization Program with respect to total outlays under the program and the distribution of these outlays across provinces. This examination will be conducted in two parts. First, the implications of equalizing natural resource revenues to different degrees and in different ways will be examined for the 1980/81 fiscal year. Second, the forecasts of equalization payments to 1986/87 under the current program and with several changes in the program will be presented.

The Impact on Entitlements of Various Approaches to Equalizing Natural Resource Revenues

It will be recalled that the current program employs the representative tax system approach to equalize revenues from different sources. Positive and negative entitlements to equalization payments are calculated separately for 29 different revenue sources, including 10 different types of resource revenues. It will also be recalled that *renewable* resource revenues are fully equalized in the program, while only 50 per cent of *non-renewable* resource revenues are equalized; revenues from the sale of Crown leases are not equalized at all.

Table 5-1 shows the impact on the equalization entitlements of the provinces in 1980/81 when treating natural resources as we do in the current program; then it shows what would have resulted from the adoption of five alternative methods of equalizing resource revenues. The table also indicates the implications for total equalization payments of including and excluding the "personal income override."

In Case 1, all resource revenues in the current formula, together with revenues from the sale of Crown leases, are taken into account; only 17.5 per cent of the revenues in each of the 10 resource categories is equalized, however. This approach is in line with that developed in Chapter 3. In this particular case, it is assumed that there is an allowance of 30 per cent for natural resource revenues to be deposited in a heritage-type fund, which would not be equalized in the current year. For the remaining 70 per cent of provincial resource revenues, it is assumed that the amount to be equalized is that which would be payable if those revenues were treated as personal income and hence were subject to federal income tax. For simplicity, a federal per-

Table 5-1

Equalization Entitlements, by Province, and Total Equalization Payments under the Current Program, with Simulations of Alternative Approaches to Equalizing Natural Resource Revenues, Canada, 1980/81

	Entitlements										Total payments[1]	
	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	A	B
	($ Millions)											
Current program	376.4	88.0	449.1	378.7	1,720.8	265.2	342.6	40.2	-3,008.7	-652.3	3,395.9	3,661.1
Case 1	357.9	77.0	381.0	337.5	1,290.4	-358.5	270.6	75.2	-1,883.5	-547.4	2,789.6	2,789.6
Case 2	443.7	107.4	574.6	480.0	2,642.3	1,501.5	487.4	-82.6	-5,504.8	-649.1	4,735.4	6,236.9
Case 3	333.5	101.6	535.7	343.5	932.1	620.1	165.0	113.9	-2,731.4	-413.9	2,525.3	3,145.4
Case 4	350.4	79.4	396.1	331.4	1,152.4	-296.4	239.5	88.1	-1,835.0	-505.7	2,637.3	2,637.3
Case 5	400.8	121.0	661.2	444.8	1,853.6	1,856.4	309.7	-8.9	-5,227.4	-410.8	3,791.1	5,647.5

Case 1 - Natural resource revenues[2] equalized at 17.5 per cent.
Case 2 - Natural resource revenues[2] equalized in full.
Case 3 - Natural resource revenues equalized as in current program except that hydro rents replace water power rentals.
Case 4 - Natural resource revenues,[2] with hydro rents instead of water power rentals, equalized at 17.5 per cent.
Case 5 - Natural resource revenues,[2] with hydro rents instead of water power rentals, equalized in full.

1 A (with) and B (without) personal income override.
2 Including revenues from the sale of Crown leases.
SOURCE Current program estimates for 1980/81 are from Department of Finance, "Provincial Fiscal Equalization Tables: Third Estimates, 1980-81"; all other estimates are by the Economic Council of Canada.

sonal income tax rate of 25 per cent has been applied to the 70 per cent, yielding 17.5 per cent of resource revenues to be equalized.[1]

In Case 2, all natural resource revenues included in the present equalization formula, plus revenues from the sale of Crown leases, are *fully* equalized (rather than only 17.5 per cent, as in the previous case).

Case 3 corresponds to the current program, and Cases 4 and 5 correspond to Cases 1 and 2, respectively, except that hydro-electricity rents received by provincial residents are substituted for the "water power rentals" included in the current formula.[2]

The Exclusion of Hydro Rents

The major implications of possible changes in the treatment of resource revenues when rents from the production of hydro-electricity are excluded from the calculation of such revenues can be quickly summarized. Case 2 in Table 5-1 indicates that in the absence of the "personal income override" full equalization in 1980/81 of resource revenues apart from hydro rents would have resulted in an 84 per cent increase in equalization payments. Moreover, Ontario would have received $1.5 billion in equalization payments. Little needs to be said about the practical possibilities of implementing this change.

Case 1 indicates that equalizing 17.5 per cent of resource revenues other than hydro rents would have decreased outlays on the program in 1980/81 by 18 per cent. Ontario would no longer have positive entitlement to equalization payments. Most provinces now receiving equalization payments would receive from 5 to 25 per cent less.

The Inclusion of Hydro Rents

It was suggested in Chapter 4 that Crown corporations involved in the production of hydro-electricity in effect pass on some of the revenues from such production through their pricing policies. Estimates of these implicit rents are included in Cases 3 to 5 of Table 5-1. Since our objective is to see what difference is made by the inclusion of hydro rents, each simulation in Cases 3 to 5 can be compared directly with the current program and with Cases 1 and 2, respectively.

It should be noted that hydro rents received by consumers were estimated in Chapter 4 at about $3.3 billion in 1980, which is almost equal to the total amount of $3.4 billion in resource revenues that will be equalized under the current program in 1980/81. If all revenues in the current program, as well as revenues from the sale of Crown leases, were equalized in full, then resource revenues to be equalized would total about $7 billion. Hydro rents received by consumers would still be large in relation to this total.

It is interesting to compare total outlays on equalization and their distribution in the current program with the outcome that would result if the hydro rents

passed on to consumers were included in the equalization formula *in the same way as any other renewable resource revenue.*[3] As noted earlier, all renewable resource revenues are fully equalized in the current program, while only 50 per cent of some non-renewable resource revenues are equalized, and other non-renewable resource revenues are not equalized at all. Comparing outlays in Case 3 with those under the current program, we see that very substantial changes would take place in outlays on equalization and their distribution. Even if the "personal income override" provision in the current program were abolished, outlays on equalization would decrease by over 7 per cent from their present level. Equalization payments to Quebec and Manitoba would be approximately half what they are in the present program. Ontario would have entitlements to $620 million in equalization payments – more than double its present entitlements.

The principal lesson to be learned from Case 3 pertains to the major consequences that result from the arbitrary way in which different types of resource revenues are treated in the current Equalization Program and the problems this creates for reform. To ascertain the effects of equalizing hydro rents if resource revenues were to be treated uniformly in the Equalization Program, it is necessary to compare other simulations in Table 5-1. The effects can be illustrated by comparing Cases 1 and 4, where a uniform rate of 17.5 per cent of all resource revenues is equalized. Here, the inclusion of hydro rents would lower equalization payments by 5.5 per cent. The effects can also be illustrated by comparing Cases 2 and 5, where resource revenues are fully equalized. In this case, outlays on equalization would decrease by 9.5 per cent in the absence of the "personal income override."

These comparisons have a common-sense interpretation. The Equalization Program responds to the fact that resource revenues are unequally distributed across the nation. If hydro rents were treated like any other form of natural resource revenue, differences in provincial resource endowments would be reduced and so would equalization payments.

If resource revenues were treated uniformly in the equalization formula and hydro rents were also included, the expected effect would be to reduce payments to provinces whose residents use large amounts of hydro-electricity and to increase payments to provinces with below-average consumption of hydro-electricity. This turns out to be the case. Comparing Cases 1 and 4, where 17.5 per cent of all resource revenues are equalized, the inclusion of hydro rents reduces equalization payments to Manitoba and Quebec by around 11 per cent and increases payments to Prince Edward Island and Nova Scotia by about 3 to 4 per cent. Equalizing a greater percentage of resource revenues has the effect of magnifying these changes. In Cases 2 and 5, where all resource revenues are fully equalized, the effect of including hydro rents would be to reduce equalization payments to Manitoba and Quebec by about one-third and to increase payments to Prince Edward Island and Nova Scotia by 13 to 15 per cent.

Projections of Equalization Payments

In this section, we present estimates of total equalization payments for the period 1980/81 to 1986/87 under the current program and under a range of different formulas. These results incorporate estimates of oil and gas revenues that the producing provinces will receive as a result of the energy agreements recently signed between them and the federal government.

To derive these estimates, we have employed a provincial econometric model that has been linked to the Economic Council's CANDIDE model in order to project the economic circumstances of the provinces over the forecast period.

It should be recognized that forecasting equalization payments involves great difficulties. The level of payments in a given year is dependent not only on the revenues of all provincial governments from a variety of sources, but more particularly on the disparities in the provinces' shares of these tax bases relative to their shares of the population. Small changes in a province's share of population or its share of a given tax base can result in a proportionately much larger change in its equalization entitlement for that revenue source.

In this regard, it should be noted that our projections of equalization payments under the current program and in the other cases considered are strongly influenced by our forecast of economic circumstances in Quebec, which has traditionally received a large proportion of the total amount of equalization payments. Specifically, our forecast indicates a declining share of population in Quebec but, at the same time, a relatively slower rate of decline in that province's share of the major tax bases, other than those related to natural resource revenues. Consequently, Quebec's revenue capacity is forecast to improve in relative terms, with the result that equalization payments to that province are projected to grow over the period at a slower rate than for the other traditional "have-not" provinces. If our forecast with respect to Quebec is in error on this account, equalization payments to that province and in total would be higher than the levels projected.

Our focus, therefore, is not so much on the level of payments that we have forecast as on the differences in payments under the various formulas. Since the results for all cases reflect any errors in forecasting to a similar degree, the relationship between the outcomes of the various cases are likely to be fairly realistic.

We have not included the equalization of hydro-electricity rents in any of the cases presented below. The analysis in the previous section suggests that the equalization of such rents would reduce the level of equalization payments under any of the programs considered in this section.

Table 5-2

Forecast of Total Equalization Payments: Current Program and Various Alternatives, Canada, 1980/81 to 1986/87

	Equalization payments							Average annual compound rate of growth	
	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1981/82 to 1986/87	From current program 1981/82 to 1986/87
	($ Millions)							(Per cent)	
Current program	3,395.9	3,861.3	4,474.3	5,104.7	5,646.2	6,229.1	6,804.0	12.0	12.0
Case A	3,661.1	4,251.4	5,138.7	5,833.6	6,464.1	7,120.1	7,763.0	12.8	15.0
Case B	3,842.0	4,413.1	5,338.1	6,390.9	7,038.0	7,698.9	8,318.7	13.5	16.6
Case C	4,574.1	5,143.2	5,659.0	6,376.3	7,017.8	7,666.4	8,276.1	10.0	16.5
Case D	6,423.4	7,221.0	9,249.9	11,406.0	13,586.0	15,682.0	17,563.9	19.5	35.4
Case E	3,136.5	3,450.0	3,864.6	4,441.6	4,953.7	5,469.0	5,947.3	11.5	9.0
Case F	3,842.0[1]	4,413.1[1]	4,850.3	5,485.3	6,123.5	6,724.4	7,361.1	10.8	13.8

Case A - Current program; no personal income override.
(Cases B to F, inclusive - all local property taxes equalized; no personal income override.)
Case B - One-third cap on equalization of natural resource revenues.
Case C - Natural resource revenues[2] equalized in full before one-third cap is applied.
Case D - Natural resource revenues[2] equalized in full; no cap.
Case E - Natural resource revenues[2] equalized at 17.5 per cent; the estimates assume that no monies are withdrawn from heritage-type funds by provincial governments during the forecast period.
Case F - Beginning in 1982/83, natural resource revenues[2] are equalized in full in the first instance, but the sum of net positive entitlements for resource revenue categories (for those provinces with net positive entitlements) is constrained to grow each year no faster than GNP. The sum of the positive resource entitlements of the provinces for 1981/82 in the current program is used as a base for escalation.

1 Same as in Case B.
2 Including revenues from the sale of Crown leases.
SOURCE Current program estimates for 1980/81 are from Department of Finance, "Provincial Fiscal Equalization Tables: Third Estimate, 1980-81"; all other estimates are by the Economic Council of Canada.

Table 5-3

Projected Equalization Entitlements, by Province, and Total Equalization Payments: Current Program and Various Alternatives, Canada, 1982/83 and 1986/87

	Entitlements										
	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Total payments
	($ Millions)										
1982/83											
Current program	490.6	117.7	614.9	513.1	2,256.6	-	481.4	-36.3	-4,423.8	-679.0	4,474.3
Case A	490.6	117.7	614.9	513.1	2,256.6	664.4	481.4	-36.3	-4,423.8	-679.0	5,138.7
Case B	562.8	130.2	690.9	568.1	2,392.2	508.7	485.2	-57.4	-4,563.5	-717.6	5,338.1
Case C	580.5	131.3	702.9	583.3	2,508.6	649.0	503.4	-82.4	-4,929.7	-647.3	5,659.0
Case D	654.6	159.5	883.6	723.5	3,751.7	2,383.7	693.3	-269.0	-8,448.4	-533.0	9,249.9
Case E	533.3	113.3	587.9	494.1	1,717.2	-455.3	382.4	36.4	-2,689.5	-720.0	3,864.6
Case F	563.8	124.9	662.2	551.8	2,228.6	258.4	460.6	-40.3	-4,137.3	-673.0	4,850.3
1986/87											
Current program	832.5	193.6	1,084.0	906.1	2,893.5	-	894.3	-208.8	-6,779.1	-776.1	6,804.0
Case A	832.5	193.6	1,084.0	906.1	2,893.5	959.0	894.3	-208.8	-6,779.1	-776.1	7,763.0
Case B	968.0	218.2	1,216.6	978.6	3,052.6	980.5	904.2	-299.0	-7,247.4	-773.1	8,318.7
Case C	976.5	216.5	1,211.0	977.6	3,040.1	946.8	905.6	-290.1	-7,218.3	-768.4	8,276.1
Case D	1,214.0	287.1	1,671.1	1,364.2	6,137.3	5,494.8	1,395.4	-880.8	-16,387.0	-298.1	17,563.9
Case E	909.8	195.9	1,076.9	864.8	2,137.1	-379.0	762.8	-117.9	-4,545.3	-905.5	5,947.3
Case F	955.3	209.5	1,165.8	939.5	2,734.5	499.1	857.4	-231.9	-6,314.5	-814.7	7,361.1

SOURCE Estimates by the Economic Council of Canada.

The projections of total equalization payments for the current program and for each of the cases considered are presented in Table 5-2 for the fiscal years 1980/81 to 1986/87. The estimates of the total entitlements of each of the provinces for the 1982/83 and 1986/87 fiscal years for these cases are provided in Table 5-3.

The projections indicate that if the Equalization Program were continued in its present form, total payments would increase to $6.8 billion for the 1986/87 fiscal year, representing an average annual compound rate of growth of 12 per cent from the estimate of $3.86 billion in 1981/82. The projections also show that the one-third constraint with regard to the equalization of natural resource revenues would not become effective until the 1982/83 fiscal year.[4]

The only modification made to the current program in Case A is the removal of the "personal income override," as a consequence of which Ontario becomes eligible to receive equalization payments. In this case, it is estimated that total payments would have increased by about 8 per cent to $3.66 billion in 1980/81, as a result of the receipt by Ontario of around $265 million. We project that by 1986/87 total payments will amount to $7.76 billion, which is some $960 million higher than the estimate for the current program because of the payments that would be made to Ontario.

Case B forecasts equalization payments with an additional change – that is, with all local property tax revenues being equalized, instead of only revenues related to education, as in the current program. This change would influence payments in several ways. First, it would reduce Ontario's positive entitlements and payments because that province has an above-average per capita tax base in the case of local property taxes. The entitlements and payments to the five eastern provinces and Manitoba would increase for the opposite reason. As a result of these latter increases, the extent to which natural resource revenues could be equalized under the one-third limitation would rise. With this additional change in place, we project that the limitation would not become effective until one year later than the current program, in 1983/84.

If all local property taxes had been included in 1980/81, total payments would have been about $3.84 billion – some $450 million higher than under the current program and about $180 million more than in Case A, in which case Ontario is assumed to be eligible to receive payments but local property tax revenues are not fully equalized. Our projections indicate that by 1986/87, payments would rise to $8.32 billion, approximately 22 per cent more than under the current program and about 7 per cent more than in Case A, with only the "personal income override" removed.

It was argued in Chapter 3 that all resource revenues should be equalized on the same basis. This approach is reflected in Case C, where revenues from non-renewable resources and from the sale of Crown leases are equalized in full before the one-third constraint is applied. The effect of this additional change is that the constraint would have first become effective in 1980/81. By contrast, the constraint would only become effective in 1983/84 under Case B; thereafter, equalizing all resource revenues in full before the one-third cap is applied would result in only minimal changes in the level of total payments. In 1980/81, however, payments under Case C would have been about $4.57 billion, or 19 per cent higher than under Case B and almost 35 per cent higher than under the current program.

Case D shows what the equalization payments would be if all resource revenues were fully equalized (that is, if the one-third constraint on the equalization of resource revenues applied in Case C were removed). Equalization payments would have been about $6.4 billion in 1980/81, over 40 per cent higher than in Case C and close to twice the level of $3.4 billion under the current program. Our projection indicates that, by 1986/87, payments would have risen to about $17.6 billion, more than two and one-half times the level forecast for the present program. The magnitude of this estimate makes it obvious why the federal government felt compelled to impose tight limits on the equalization payments that result from natural resource revenues.

Case E provides an estimate of the financial implications of equalizing resource revenues in line with the narrow-based approach to equity outlined in Chapter 3, under which provinces are regarded as having property rights over natural resources. Specifically, all natural resource revenues are taken into account, but only a portion of those revenues in each of the resource revenue categories is equalized. We have invoked the same assumptions as in the previous section, so that only 17.5 per cent of resource revenues are equalized. This case also incorporates the assumptions that the "personal income override" is not in effect and that local property tax revenues are fully equalized. In Case E, total payments would be lower than under the current program throughout the period; they would have been about $260 million, or 7.5 per cent lower in 1980/81 and about 11 to 14 per cent lower in each year during the forecast period.

In the last case, Case F, we maintain the assumptions that the "personal income override" is not in effect; that municipal property tax revenues are fully equalized; and that all resource revenues, including the revenues from the sale of Crown leases, are taken into account, as in Case C. A different constraint is applied than in Case C and in the current program, however, with respect to the equalization of resource revenues. In this case, beginning in 1982/83, the sum of net positive entitlements for all resource revenue categories (for those provinces with net positive resource revenue entitlements) is constrained to grow each year at a rate no higher than the rate of growth of GNP. In order to determine this constrained sum for 1982/83, some baseline level had to be chosen for 1981/82; the base that we have chosen for that year is the total for 1981/82 under the current program.

With this constraint in place, our projections indicate that the payments in 1982/83 would initially be about $800 million (14 per cent) lower than in Case C; in 1986/87, however, they would be about $900 million (11 per cent) lower. With the changes from the current program in place in Case F, we project that payments in 1982/83 and 1986/87 would be about 8 per cent higher than under the current program. Ontario would be the major beneficiary of these changes in the current program. Of the total projected increase in payments of about $560 million in 1986/87, payments to Ontario are estimated at about $500 million.

Conclusions

An examination of the estimated impact in 1980/81 of various alternatives to the current formula for equalizing resource revenues indicates that the lack of uniform treatment of these revenues in the current formula creates problems that need to be redressed.

Equalizing a smaller but uniform proportion of resource revenues, as suggested in Chapter 3, would not only reduce equalization payments directly, but it would also eliminate the need for a "personal income override" that prevents Ontario from qualifying for equalization payments. Using the equalization rate for natural resources suggested under the approach developed in Chapter 3, payments would be 18 per cent lower than under the present program, and 22 per cent lower if hydro rents were treated as a natural resource revenue.

The inclusion of hydro rents reduces equalization payments because it results in a much more even distribution of resource revenues across the nation than is reflected in the current equalization formula. Provinces such as Manitoba and Quebec, whose residents derive substantial benefit from the consumption of large amounts of subsidized hydro-electricity, would lose from the inclusion of hydro rents in the equalization formula, while provinces, such as Prince Edward Island and Nova Scotia, that consume less hydro-electricity would be the principal beneficiaries from the equalization of hydro rents.

Looking to the immediate future, our projections indicate that should the Equalization Program continue in its current form, payments would amount to $6.8 billion in 1986/87 – double the level in 1980/81. This projection is based on a forecast of relative improvement in the fiscal capacity of Quebec. Should such an improvement not materialize, payments would most likely rise even more rapidly.

With the introduction of two modifications – namely, the removal of the "personal income override" (which would enable Ontario to become eligible to receive payments) and the equalization of all municipal property tax revenues – payments are projected to rise to $8.3 billion by 1986/87, $1.5 billion more than under the current program.

If, in addition to these two changes, total positive equalization entitlements in natural resource revenue categories were constrained to grow no faster than gross national product beginning in 1982/83, we project that total payments would rise to about $7.4 billion by 1986/87. Total equalization payments in this case would be higher than under the current program from 1982/83 onward, however, amounting to about $560 million more in 1986/87.

It should be noted as well that the extent to which natural resource revenues would be equalized under this modified constraint is greater than that which would follow from the application of the principles proposed in Chapter 3. Based on our assumptions, we have projected that payments would rise to only about $6 billion by 1986/87.

6 Established Programs Financing and Social Policy

Hospital insurance, medical insurance, and post-secondary education occupy a central position in federal-provincial fiscal arrangements. While they are all administered by the provinces, they receive substantial financial support from the federal government. In 1980/81, the value to the provinces of federal cash grants and of the revenue from personal income and corporate taxation points yielded by the federal government for these programs amounted to some $9.6 billion, as shown in Table 6-1, which is considerably more than the federal equalization payments of $3.4 billion in that same year.

The impetus for the establishment of the health care and postsecondary education programs on a nationwide basis came from the cost-sharing measures developed by the federal government in the postwar era as a means of greatly expanding social services, which constitutionally were largely under the jurisdiction of the provinces.

Under the arrangement in effect prior to 1977, the federal government carried out detailed audits to ensure that provincial expenditures on health care and postsecondary education were strictly confined to areas that qualified for the sharing of costs. The close scrutiny maintained by Ottawa over outlays in these fields created growing exasperation among the provinces. At the same time, however, the federal government found itself facing considerable difficulty in trying to control provincial expenditures that were within the cost-sharing categories established by law and regulation.

With the adoption of the Fiscal Arrangements Act in 1977, the hospital insurance, medical insurance, and postsecondary education programs came under what was termed "Established Programs Financing." (In addition, the Act provided for a new Extended Health Care Grant to encourage the development of a broader spectrum of health services by the provinces.) Under the new EPF arrangement, cost sharing was replaced by block funding. While the provinces agreed to continue to adhere to the broad objectives established previously for these three programs, federal transfers no longer remained linked to provincial costs. The federal government in the process

Table 6-1
Major Federal Transfers as Specific-Purpose Grants to Provinces and Territories, Canada, 1980/81

	Cash transfers	Quebec tax abatements	Tax transfers[1]	Total transfers
		($ Millions)		
Established Programs Financing	5,190.6	473.5	3,906.9	9,571.0
Extended Health Care Grant	642.1	–	–	642.1
Canada Assistance Plan	1,802.3	268.0	–	2,070.3
Other specific grants[2]	1,166.8	–	–	1,166.8
Total specific grants	8,801.8	741.5	3,906.9	13,450.2
		(Per cent)		
Proportion of total provincial revenue[3]	15.1	1.3	6.7	23.0
Proportion of total federal expenditure[3]	14.1	1.2	6.3	21.5

1 Tax transfers include the value of associated equalization payments.
2 Other specific grants cover the following: the health resources fund, other health and welfare grants, bilingual education, economic development, crop insurance, territorial financial agreements, and municipal grants.
3 Total provincial revenue in 1980/81 was estimated to be $58,398.9 million; total federal cash outflow plus the value of tax transfers and the Quebec tax abatements was estimated to be $62,458.1 million in the same year.
SOURCE Estimates by the Economic Council of Canada, based on data from the Department of Finance.

gave up a substantial measure of control over the manner in which these transfers were expended by the provinces; at the same time, however, it gained a greater measure of control over the costs it was required to incur for these programs. For their part, provincial governments acquired considerably greater freedom to allocate expenditures in these areas in line with their own priorities.

Despite their increasing criticism of the then existing system, the provinces strongly resisted the federal government's proposal on the adoption of block funding when it was first put forward in 1973 because of their overriding concern that the financial resources to be provided by the federal government would fail to keep pace with rapidly rising program costs. Conversely, the federal government was anxious to establish block funding for the very purpose of achieving better control over escalating program expenditures. At the same time, it was prepared to relinquish a significant measure of control over the scale and scope of these programs out of the conviction that because these programs were established and mature the provinces were not likely to make major changes in their structure.

Since the introduction of EPF in 1977, the federal contribution has not been linked to program costs. The federal government has transferred "tax room" to the provinces by reducing its personal and corporate income tax, thus enabling the provincial governments to increase their own levies in these fields. In addition, the federal government has been making substantial cash payments to the provinces, which are escalated in line with the growth of gross national product. An outline of the old and new systems can be found in Appendix C.

Established Programs Financing introduced a considerable measure of flexibility into the federal specific-purpose grants. As noted previously, the provinces were given greater freedom to allocate their expenditures among hospital insurance, medical insurance, and postsecondary education, according to their own priorities. Moreover, EPF was generally perceived to have given the provinces a stronger incentive to be efficient, since resulting cost savings do not lead to a loss in federal funds, as was the case under some of the old cost-sharing arrangements.

Notwithstanding its advantages, EPF has also generated a number of concerns. Some public interest groups have raised fears that the new freedom of the provinces from federal constraints has led them to reduce the level, and thus the quality, of health and postsecondary education services. Alternatively, the concern has been expressed that at least some provinces may increase the burden on individual Canadians by way of a variety of user charges, such as higher tuition fees for postsecondary education and further charges over and above those covered by insurance for hospital or physicians' services. As for the federal government, it has already declared its dissatisfaction with certain elements of EPF because of the lack of enforceable program conditions and the growth of its financial burden as a share of program costs.

On the eve of the renegotiation of EPF for another five-year period, it is timely and appropriate to appraise the success and shortcomings of the program. The following section addresses the fundamental issue of the role of the federal government in health insurance and postsecondary education – two areas that fall primarily under the constitutional jurisdiction of the provinces – and describes the emergence of federal specific-purpose grants and, ultimately, the EPF program. The discussion then turns to the more immediate issue of whether the provinces have maintained reasonable service standards since the introduction of EPF. The next topic for consideration is the broad issue of fairness as it relates to the burden of the program costs assumed by the federal government relative to that of the provinces and to the ability of the less wealthy provinces to provide services comparable to those in wealthier provinces. The final section summarizes the findings of the chapter.

The Fundamental Issue: Jurisdiction

The fundamental issue is whether the federal government should use transfers to the provinces as a means of shaping social policies in those areas which are largely under provincial jurisdiction. Should national standards override provincial priorities and, if so, should such standards be imposed by the federal government?

The question is highly relevant in this case because social policy falls largely under provincial jurisdiction. The federal government was able to introduce such programs as unemployment insurance, old age pensions, and family allowances either through constitutional amendment or agreement with the provinces. The Constitution, however, placed major constraints on federal involvement in the administration of social programs in the areas of hospital and medical insurance, postsecondary education, and social assistance. In order to fulfill what it considered to be an increasingly important national role in these areas, the federal government circumvented the difficulties by giving the provinces conditional grants that were specifically earmarked for such purposes.

The most important, yet most controversial, rationale for federal involvement in the areas of health

insurance and postsecondary education is the need to establish "national standards" so as to ensure access to a certain minimum level of essential services by all Canadians.

The importance of establishing national health care standards was strongly emphasized by the Royal Commission on Health Services. Through the "Health Charter for Canadians" proposed in its 1964 Report, the Commission underscored the importance of a comprehensive, universal health program for all Canadians.[1] These objectives served as the basis of the federal conditions attached to the shared-cost medical insurance program that came into operation in 1968. More recently, the Honourable Emmett Hall, who served as Chairman of the 1964 Royal Commission, was again called upon to review health services in Canada. In his latest report he emphasized once more the need to maintain national health standards.[2]

In the absence of substantial federal support for postsecondary education, provinces might have been unwilling to devote adequate resources to this area since much of the benefits could accrue to other provinces because of the wide-scale migration of students and graduates. Beyond the broad support that it provides for postsecondary education generally under EPF, the federal government has also assumed responsibility for the financing of certain specific postsecondary activities where constitutional jurisdiction is less clear. These include research in the natural and social sciences, manpower training, student loans, and international educational support. The federal government has committed substantial funds to these activities – in fact, a total of around $2 billion for 1981/82.[3]

At the same time, however, a number of studies on Canadian federalism – such as that by Quebec's Royal Commission of Inquiry on Constitutional Problems in 1956 and the 1980 report of the Constitutional Committee of the Quebec Liberal Party – have strongly supported the maintenance of provincial autonomy within areas under the constitutional jurisdiction of the provinces.[4] These reports have also contended that provincial governments are not only in a better position to establish priorities within certain areas, in accord with the preferences of their constituents, but they can more effectively oversee the operations of these programs.

Another recent inquiry, that of the federal Task Force on Canadian Unity, recommended that conditional grants be introduced only if they receive wide regional support and then only if they are subject to the proviso that "provinces should be granted the right to opt out of any such program, and where appropriate receive fiscal compensation."[5] Such an opting-out provision would make it impossible for the federal government to impose conditions against the will of the provinces.[6]

Despite this controversy over jurisdictional issues, there was nevertheless broad popular and provincial support at the time of their introduction for shared-cost programs involving hospital insurance and postsecondary education. Federal authorities considered it necessary for their government to cover at least half the average operating costs of these programs in order to provide sufficient incentive to the provinces to establish comprehensive hospital insurance plans and to expand postsecondary education to what they considered to be an acceptable level. Cost sharing was viewed as a means of ensuring that federal payments would keep pace with rapidly escalating provincial expenditures for these purposes.

Increasingly, however, shared-cost programs became a source of contention between the two levels of government. The introduction in 1968 of the shared-cost medical insurance program encountered serious opposition, with a number of provinces regarding the federal initiative as an attempt to gain political credit at the expense of provincial autonomy through the use of its "power of the purse." Provinces further complained that the costs they would be required to incur in establishing the kind of comprehensive medical insurance scheme contemplated by the federal government might not conform to their own spending priorities.

By removing the alleged distortions in provincial spending associated with shared-cost financing, and thereby ending the need for detailed federal audits of provincial spending in the fields of health insurance and postsecondary education, EPF served to eliminate a source of continuing friction between the two levels of government. As a financial mechanism, it has been broadly accepted by the federal government and the majority of provincial governments.[7]

There are, however, indications that the federal government has some serious misgivings about the decline in its power over the maintenance of the basic elements of health care under EPF. The current health insurance conditions, which are outlined in Appendix C, are so broad that they defy practical application; and, moreover, no mechanism of enforcement is included in the EPF agreement. In the case of postsecondary education programs, however, it should be noted that no conditions have ever been laid down by the federal government.

The Immediate Issue: Provincial Spending

In the years leading to the introduction of EPF, there was much discussion about the need to control rapidly rising program costs. In an effort to encourage cost containment, the federal Minister of Health and Welfare, on the eve of the introduction of EPF, stated that:

> Any savings that can be generated by reducing the services would accrue totally to the provinces and would not be shared by the federal government, since our contribution under Established Programs would not be directly related to program costs.[6]

The more recent concern, however, has been that the provinces have gone too far in restraining their spending and are failing to provide an adequate level of services. It was this concern that led the federal government in 1979 to appoint the Honourable Emmett Hall to carry out his review of Canadian health services, as mentioned in the previous section.

The question that needs to be considered, then, is whether the provinces have maintained the same levels of health and postsecondary education services since the introduction of EPF, in light of the much greater scope provided under this new approach for them to undertake expenditures in line with their own priorities. The answer to the question, however, is far from straightforward. For one thing, the levels of service being provided by each province are not easily measured. Besides, the variations between provinces in the level of services may reflect the impact of a wide variety of different factors, such as demography and wage levels, which make it difficult to render precise comparisons.

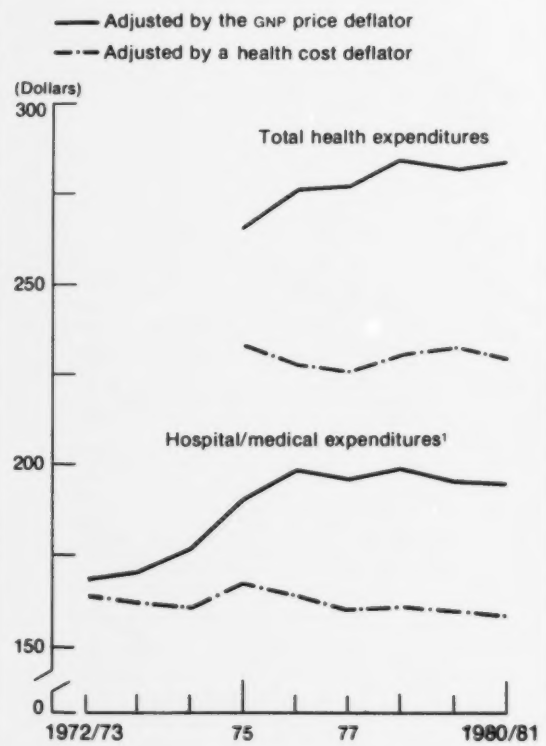
Trends in Provincial Health Expenditures

Ideally, the appropriateness of provincial health expenditures should be measured in terms of their ultimate impact on the health status of Canadians. A partial measure of this kind is undertaken in the following chapter, on the basis of detailed hospital and medical expenditure data; unfortunately, however, these data are not available for the EPF period. Thus the aggregate figures that are used here – and do cover the EPF period – should be viewed as only crude proxies of the level of health services.

Chart 6-1 shows real per capita provincial health expenditures after adjusting for inflation trends. Two types of health expenditure are covered: 1/ hospital and medical operating costs, for which the provinces receive federal funds under the EPF program; and 2/ the total health expenditures undertaken by provincial governments, which, in addition to the above costs, include such items as hospital capital costs, public health, dental care, paramedical services, and the services of pharmacists. In converting current expenditures to real expenditures, two alternative price deflators were employed: 1/ the GNP price deflator, which reflects the rate of inflation of all goods and services produced in the country; and 2/ a health cost deflator, reflecting the increases in physicians' fee schedules (based on Ontario's experience) and the increases in wages and salaries and in the prices of goods and services used in the hospital sector. Both deflators have technical limitations; however, they are useful in presenting a broad picture of the trend in the level of health services provided by the public sector.

Chart 6-1

Provincial Government Total Health Expenditures per Capita, Canada, 1972/73 to 1980/81
(In constant 1971 dollars)



1 Hospital and medical insurance operating costs for the period 1972/73 to 1976/77 refer to the costs shared by the federal government. Operating costs for the remaining years are based on estimates by Health and Welfare Canada. To make the two series compatible, the Health and Welfare estimates for the period after 1977 were multiplied by the ratio of actual to estimated "shared" operating costs in 1976/77.

SOURCE Estimates by the Economic Council of Canada, based on data from Health and Welfare Canada.

The general impression derived from Chart 6-1 is that there has been a leveling-off, or even small decline, in the real per capita expenditures on health since the introduction of EPF in 1977. A comparison of the figures for the most recent year (1980/81) with those for the year preceding the introduction of EPF shows that, on a per capita basis, real total health expenditures have remained practically unchanged since EPF was established, while real hospital and medical expenditures have experienced a small decline of about 4 per cent.

The fact that real per capita hospital and medical expenditures have declined since the introduction of EPF, while real total health expenditures per capita have not, indicates that some shift of resources has taken place towards health services other than those covered by hospital and medical insurance. This is perhaps in response to the goal of EPF to upgrade health services that were not covered under the old cost-sharing arrangements.

Before the introduction of EPF, the health cost deflator was escalating faster than the general price level in the economy; since then, however, it has been increasing at about the same rate. Despite the limitations of the price deflators employed, this is an indication that since 1977 the provinces have been more successful in controlling health costs.

Table 6-2 looks at the experience of individual provinces based on an index of real total health expenditures per capita. Table 6-2 shows that, in relation to the year prior to EPF (for which the index was set to equal 100 for all provinces), the index has not changed uniformly in all provinces since 1977. Over the period from 1976/77 to 1980/81, the most substantial decrease (4.1 per cent) took place in Ontario. On the other hand, the index increased in Alberta (10.8 per cent) and in British Columbia (14.0 per cent). One limitation of the table stems from the fact that the national health cost deflator is used for all provinces, and this index does not take into account differences in the growth of health costs between provinces.

Table 6-2

Indexes of Real Provincial Government Total Health Expenditures[1] per Capita, Canada, by Province, 1977/78 to 1980/81

	1977/78	1978/79	1979/80	1980/81
	(1976/77 = 100.0)			
Newfoundland	96.9	99.2	101.9	102.3
Prince Edward Island	98.4	99.9	98.9	102.6
Nova Scotia	99.4	102.1	104.6	104.0
New Brunswick	100.2	101.3	100.8	98.1
Quebec	99.1	102.2	102.0	99.0
Ontario	98.9	99.2	97.9	95.9
Manitoba	99.6	96.5	96.4	97.0
Saskatchewan	102.5	101.3	106.6	104.7
Alberta	96.7	103.9	109.3	110.8
British Columbia	102.0	108.6	112.1	114.0
Canada[2]	99.3	101.6	102.2	101.1

1 Deflated by a health cost deflator.
2 Including the Yukon and the Northwest Territories.
SOURCE Based on data from Statistics Canada and from Health and Welfare Canada.

Trends in Provincial Postsecondary Education Expenditures

A picture similar to that of the provincial health expenditure trends is revealed by the trends in provincial postsecondary education expenditures (Table 6-3). Compared with the year before EPF, the real provincial postsecondary education expenditures per student were lower in 1980/81 by about 2.5 per cent. The picture varies, however, from province to province. The largest decrease occurred in Ontario, followed by Newfoundland and Manitoba. On the other hand, real spending per student increased in British Columbia and, to a lesser extent, in Nova Scotia, New Brunswick, Alberta, and Saskatchewan.

Table 6-3

Indexes of Real Provincial Government Postsecondary Education Operating Expenditures[1] per Student, Canada, 1977/78 to 1980/81

	1977/78	1978/79	1979/80	1980/81
	(1976/77 = 100.0)			
Newfoundland	97.7	103.5	97.7	90.4
Prince Edward Island	89.9	104.9	105.4	101.7
Nova Scotia	107.5	117.2	113.7	110.7
New Brunswick	100.5	100.6	115.2	109.7
Quebec	103.6	107.8	101.5	98.3
Ontario	100.7	102.6	95.2	88.1
Manitoba	110.6	101.3	100.6	93.9
Saskatchewan	102.9	114.8	106.2	105.6
Alberta	111.4	112.9	109.2	108.8
British Columbia	107.5	114.3	120.2	117.6
Canada[2]	103.7	106.9	102.1	97.5

1 Calculated on a full-time equivalent basis – i.e. full-time university and college students, plus a full-time equivalent of part-time university students, based on a conversion factor of 3 to 1 (3 part-time to 1 full-time). Expenditures were adjusted by the GNP price deflator.
2 Including the Yukon and the Northwest Territories.
SOURCE Based on data from Statistics Canada.

The above statistics could be questioned on a number of grounds. For example, expenditures were deflated by the national GNP price deflator, which may not accurately depict cost increases in post-secondary education or interprovincial differences in cost increases. In addition, with the exception of converting part-time enrolment to "full-time equivalent" enrolment, no account was taken of the cost differences between universities and colleges or between the various types of programs.

To the extent that these figures serve as a broad indicator of provincial spending trends, however, they suggest that there has been only a moderate reduction nationally in real provincial spending on post-secondary education. At the same time, student tuition fees as a proportion of total operating costs have continued to decline in all provinces – an indication that financial barriers to entry into post-secondary education have not increased.[9] The figures, however, also reveal substantial spending cuts in some provinces. This was especially the case in Ontario, where real spending per full-time equivalent student in 1980/81 was nearly 12 per cent below the 1976/77 level.

The Impact of EPF

It would appear that most provinces have not taken undue advantage of the opportunity open to them under EPF to reduce total program expenditures (although, as will be noted later, their share of program costs has been reduced, while that of the federal government has increased). More than anything else, this reflects the fact that the provinces do not respond mechanically to changes in funding arrangements but are primarily constrained by a sense of their own spending priorities, as well as by real factors affecting the demand for, and cost of, their services. It also reflects a misconception about the extent to which the previous cost-sharing arrangements provided a weaker incentive to contain spending than does EPF.

There is a view in some quarters that the old cost-sharing arrangements did not encourage the provinces to be cost-conscious because each dollar spent actually cost them only around 50 cents, on average. Thus it was anticipated that the elimination of the "50-cent dollar" under EPF would lead to significant spending restraint.

The incentive to contain costs under the old cost-sharing arrangements was not as weak as was generally believed, however. In the case of medical insurance, the federal grant per capita was the same for all provinces. It was equal to 50 per cent of the *national* per capita cost. As a result, the spending policies of individual provinces – especially the smaller ones – could have had practically no effect on the amount of funding they received from the federal government. In other words, the amount received by any province in any given year was fixed according to the established formula regardless of how spending increased or decreased in a particular province; thus each province had an incentive to contain its own costs. Even so, the costs of the program increased rapidly in the early 1970s.

In the case of hospital insurance, the incentive to contain costs was perhaps somewhat weakened by the fact that part of the federal transfer was directly linked to the level of spending in each province.

The incentive to contain costs was probably weakest in the case of postsecondary education, because the federal transfer was entirely linked to the actual expenditures in each province.[10] In 1972, however, a 15 per cent ceiling was imposed by the federal government on the annual rate of increase in grants for postsecondary education. As a result, part of the hypothesized effect of federal block grants in curtailing provincial spending may have already been induced by the previously imposed federal ceiling.

An Issue of Fairness: The Intergovernmental Fiscal Balance

The overall size of specific grants and their allocation by province are equally important considerations. Both involve broad issues of fairness.

At the same time as it has been seeking to reduce its large budget deficit, the federal government has also been modifying its spending priorities, placing more emphasis on economic development and less on social objectives. In line with this approach, as pointed out earlier in the report, the federal Minister of Finance indicated in his budget of October 1980 that he planned to reduce the level of transfers to the provinces (the bulk of which comprises payments under EPF) by $1.5 billion over the period 1982-84. In his submission to the Parliamentary Task Force established to undertake public hearings with respect to the impending renegotiation of the fiscal arrangements, the Minister of Finance contended that the surplus position of the provinces in contrast to the substantial deficit position of the federal Treasury was evidence of a "fiscal imbalance" between the two levels of government.[11] Regardless of the merits of this argument, there would appear to be conflict between the federal government's desire to maintain national standards of social services, on the one hand, and its proposed reduction in transfers to the provinces, on the other.

A further question that arises is whether the existing federal transfers are adequate to ensure that each province is in a financial position to provide comparable levels of health and postsecondary services. As pointed out in Chapter 2, specific-purpose grants help to reduce interprovincial differences in the financial capacity of provincial governments. Put simply, the larger the share of costs financed through federal specific-purpose grants, the less the provinces have to rely on their own revenue sources and therefore the smaller the significance of interprovincial differences in the ability to raise revenue from provincial tax bases.

The Federal Burden

Whereas specific federal payments were made for hospital insurance, medical insurance, and post-secondary education under the previous cost-sharing approach, block funding under EPF, as the term suggests, was intended to provide a total federal transfer with respect to the financing of these three programs with no prescribed allocation of funds between them. Looking at the ratio of EPF transfers to the cost of the three programs combined gives only a broad hint of the relative fiscal burden borne by the federal government. Comparison of the federal government's relative fiscal burden under EPF with that under the old shared-cost programs, however, is hampered by a number of factors.

First, as indicated above, EPF is a block fund, and any attempt to assign parts of it to any of the three established programs for comparison purposes would be necessarily arbitrary.

Second, it is unclear whether the "revenue guarantee offset" should be considered part of the EPF transfer. This offset corresponds to the increase in the federal offer to the provinces, during the negotiation of the 1977 Fiscal Arrangements, to settle the outstanding issue of the termination of the revenue guarantee program introduced in 1972.[12] The value of the offset in 1980/81 was about $600 million.

Third, there is an element of ambiguity as to which types of expenditures should be included under EPF funding. In the case of health expenditures, for example, if only hospital and medical insurance expenditures are included, the increase in the share covered by federal transfers will be overstated. This results from the fact that the provinces have been shifting resources into other forms of health care since the introduction of EPF. On the other hand, if all provincial health expenditures are included, one should also include all federal transfers related to provincial health expenditures, such as certain expenditures under the Canada Assistance Plan and the Extended Health Care Program that was introduced in 1977. This, however, is not a trivial exercise.

The above sources of confusion notwithstanding, it appears that federal transfers as a share of relevant provincial expenditures have increased since the introduction of EPF in 1977 (Table 6-4). The increase has been largest in the case of Newfoundland, Prince

Table 6-4
Federal Transfers[1] as a Proportion of Provincial Expenditures, Canada, by Province, 1975/76 to 1980/81

	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81
	(Per cent)					
Newfoundland	41.3	44.4	47.7	51.4	54.0	52.3
Prince Edward Island	42.0	42.3	48.0	52.2	57.6	55.0
Nova Scotia	46.3	48.0	50.0	51.8	53.6	52.6
New Brunswick	48.5	48.3	51.4	55.7	58.1	58.9
Quebec	43.7	43.7	41.0	40.7	41.7	42.1
Ontario	43.0	42.7	44.8	47.1	49.7	49.8
Manitoba	42.8	43.6	44.3	49.2	51.1	50.0
Saskatchewan	44.7	43.5	44.1	47.4	48.6	48.1
Alberta	40.7	42.2	43.3	43.6	43.2	41.1
British Columbia	39.8	41.4	42.4	43.4	44.5	43.1
Canada[2]	42.8	43.1	43.6	45.0	46.6	46.2

1 Federal transfers after 1976/77 refer to the EPF transfer minus the portion attributed to the terminated Revenue Guarantee Program. Provincial expenditures refer to provincial government total health expenditures and postsecondary education operating expenditures.
2 Including the Yukon and the Northwest Territories.
SOURCE Based on data from the Department of Finance and the Ministry of State for Social Development.

Edward Island, New Brunswick, Ontario, and Manitoba, while there has been a slight decrease in Quebec and Alberta. The differences are primarily due to the fact that the introduction of equal per capita grants under EPF favoured some provinces (mostly the lower-income ones) at the expense of other provinces.

The increase in the federal share at the national level is due primarily to the fact that federal transfers have grown faster than GNP. Using shares of GNP as a benchmark, there has been practically no decline in total provincial spending. At the same time, federal transfers – net of the "revenue guarantee offset" – were 4.5 per cent higher in 1980/81 than they would have been had they accounted for the same share of GNP as in 1976/77 (Table 6-5). In absolute terms, this represents an increase of about $400 million in 1980/81.

Table 6-5

Provincial Expenditures and Federal Transfers as a Proportion of Gross National Product, Canada, 1975/76 to 1980/81

	Provincial expenditures			
	Hospital and medical insurance	Total health expenditures	Postsecondary education operating costs	Federal transfers
	(Per cent)			
1975/76	3.81	5.29	1.29	2.82
1976/77	3.84	5.31	1.29	2.85
1977/78	3.75	5.28	1.35	2.89
1978/79	3.69	5.29	1.35	2.99
1979/80	3.58	5.17	1.28	3.01
1980/81	3.57	5.18	1.25	2.98

SOURCE Based on data from the Department of Finance and the Ministry of State for Social Development.

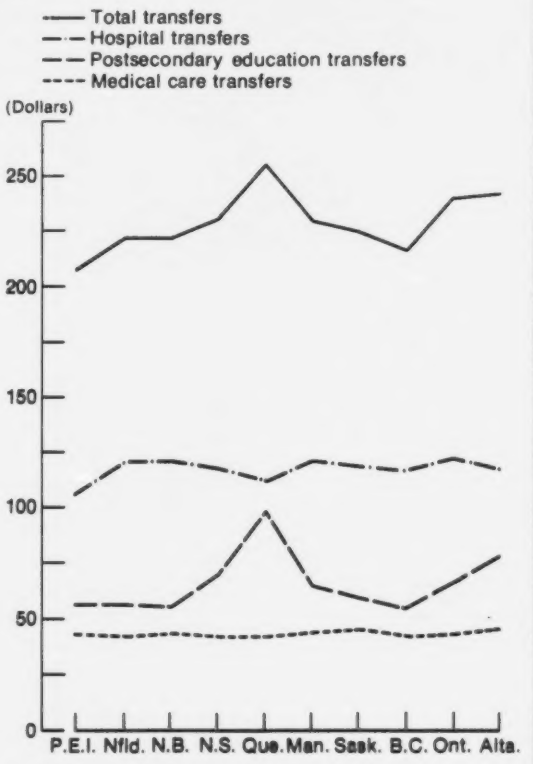
The main factor that has led to the increase in EPF transfers as a proportion of GNP is the "lagged" character of the fiscal escalator embodied in the EPF formula. The per capita value of EPF transfers grows every year by approximately the average rate of growth of GNP during the preceding four years.[13] Over the long run, therefore, the average value of EPF transfers should tend to grow at the same rate as GNP. Because the nominal rate of GNP grew substantially faster during the years preceding the introduction of EPF than it has in the years since, this has had a substantial effect on the level of EPF transfers. As a result, according to projections by the federal Department of Finance and the Council's CANDIDE model, if the EPF system continues as it did from 1977 to 1982, EPF transfers as a proportion of GNP will continue to remain above the 1976/77 level until at least the end of this decade.

The Position of the "Have-Not" Provinces

Specific-purpose grants have the effect of redistributing resources from the "have" to the "have-not" provinces because relatively higher federal revenues to finance such grants are raised, per capita, in the "have" provinces. Changes in the size and/or structure of specific-purpose grants, therefore, have particular financial implications for the

Chart 6-2

Federal Transfers[1] per Capita, Prior to Established Programs Financing, for Hospital and Medical Insurance, and for Postsecondary Education, Canada, by Province, 1976/77[2]



1 Transfers include both cash payments and the value of transferred tax points.
2 Provinces are shown in increasing order of GDP per capita in 1976.
SOURCE Estimates by the Economic Council of Canada, based on data from Department of Finance and Statistics Canada.

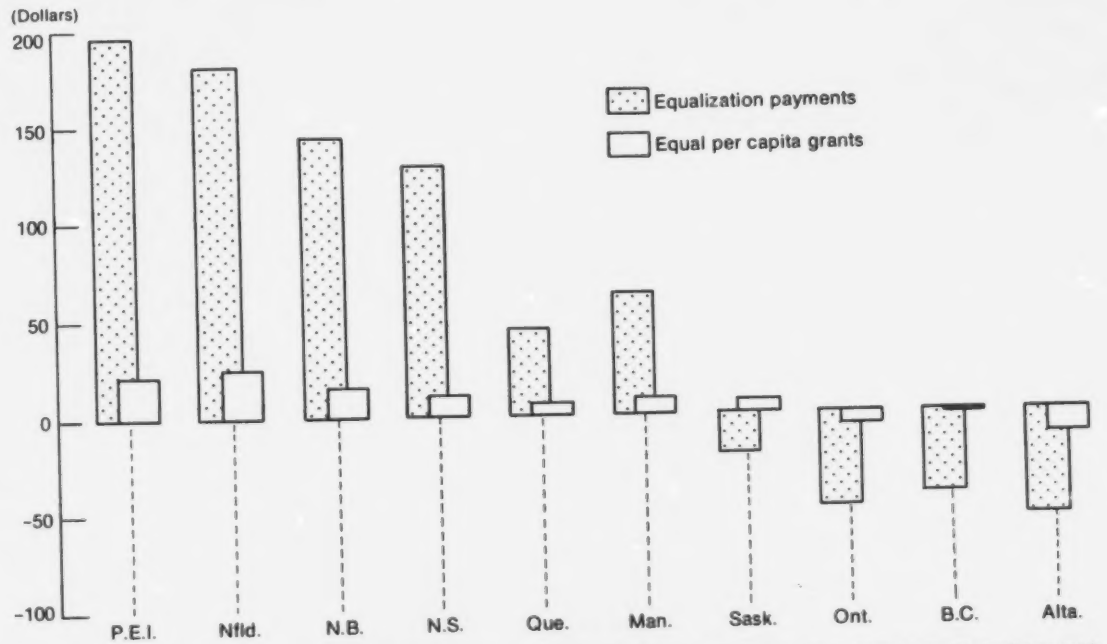
poorer provinces and their ability to maintain services at a level comparable to that in the richer provinces.

The introduction of EPF has had a mildly equalizing effect. As Chart 6-2 shows, under the old cost-shared programs some of the richer provinces received higher per capita transfers than the rest of the provinces. This was a result of their financial ability, as well as their willingness, to provide a level of health and postsecondary education services that was higher than the national average. Under the EPF arrangements, however, provinces receive the same per capita transfers regardless of their expenditures, resulting in some equalization among "have" and "have-not" provinces.

Concern about the financial ability of the poorer provinces to maintain adequate standards for particular services would not necessarily require changes to the entire EPF arrangement. Supplementary cost sharing for the "have-not" provinces, as proposed in the Hall Report, would be a less costly way to finance new services. An equally cost-effective option, which is at the same time administratively simpler and politically less contentious than a new shared-cost program, would be to increase equalization payments by increasing, for example, the total revenue equalized under the current Equalization Program. Equalization payments redistribute more funds to the "have-not" provinces than similar amounts of transfers under EPF. As Chart 6-3 indicates, the federal funds spent on equalization payments would benefit a province like Newfoundland seven times more than the same amount spent on equal per capita grants under EPF.

Chart 6-3

Net Per Capita Benefit from One Billion Dollars Spent on Equalization Payments or on Equal Per Capita Grants, Canada, by Province,[1] 1980/81



1 Provinces are shown in increasing order of GDP per capita in 1979. Equalization payments were allocated in proportion to the amount received by each province in 1980/81; the financial cost of the $1 billion in federal transfers was allocated, by province, in proportion to the amount of federal revenue raised in each province in 1979.

SOURCE Estimates by the Economic Council of Canada, based on data from Department of Finance and Statistics Canada.

Conclusions

Health care and postsecondary education services are important areas of social policy. While it is understandable that the federal government would like to play a role in these areas, it should be emphasized that the areas fall primarily under provincial constitutional jurisdiction and, as a result, federal involvement is a continuing source of contention.

Established Programs Financing has deliberately weakened federal influence over provincial spending policies and has returned more autonomy to the provinces.

The evidence presented in this chapter shows that some spending restraint – more in some provinces than others – has taken place in the areas of health and postsecondary education services; however, this was partly the objective of EPF. Even with efforts at expenditure restraint, population and labour market changes may drive up the Established Program expenditures in the next few years.

Circumstances seem to dictate that a longer period is necessary to assess the success and shortcomings of the new funding arrangements. At the very least, what is required is that relevant data be available on a timely basis to enable an adequate assessment of EPF.

Finally, if it is accepted that the essence of the 1977 agreement was that EPF payments should grow in line with GNP, then it must be acknowledged that the federal fiscal burden has increased faster than anticipated. This is entirely due to the lagged character of the fiscal escalator. Retroactive removal of the lag would cause the value of EPF as a proportion of GNP to revert to its initial level. Even under the present formula, however, the growth of the EPF payments will fall more into line with GNP growth in the next few years.

The issue of the appropriate level of federal funding should be judged from the broader perspective of federal and provincial budgetary positions, as well as the objectives of the federal government with respect to the programs affected. As pointed out in Chapter 1, there is no evidence of an overall fiscal imbalance between the two levels of government; nor is the expressed desire of the federal government to strengthen national standards in the areas of health insurance and postsecondary education consistent with a simultaneous policy of restricting federal funding.

7 Canadian Health Care Expenditures and Health Care Services

Established Programs Financing provides the provinces with funds for health insurance and post-secondary education. It is a costly program. In the fiscal year 1980/81, for example, federal transfers to the provinces amounted to approximately $17 billion. Of this amount, an estimated $9.5 billion went for Established Programs Financing in the form of cash payments and income tax transfers. A large part of this was spent on hospital insurance, medical insurance, and extended health care, making Canada's health care program the single most costly component of federal transfers.[1]

Some serious concerns have been raised with respect to the program. There is public concern that health care will become less accessible to Canadians because of budget trimming by governments and opting out by physicians. The provinces are concerned that transfers from the federal government will not be sufficient to meet the cost of health care, especially in the case of the poorer provinces. The federal government is concerned about both the growth in its expenditures and the danger that some provinces may be unwilling (and others unable) to maintain today's standards of health care if it should reduce or relinquish its role of providing financial assistance in these areas.

Federal-provincial programs of health care insurance have the central objective of providing health care to all Canadians, irrespective of income or province of residence. When programs of national health insurance were first established during the late 1950s and early 1960s, the consensus seemed to prevail that "national standards" were essential. In later years the maintenance of national standards was not considered to require uniformity of service across the country but simply the existence of certain broad principles, such as comprehensiveness of service and universality of coverage.[2]

Although it is clear from this line of reasoning that Canadian health insurance programs do not require uniform health services across the provinces, federal transfers to provinces for the medical insurance program have been based for many years on per capita allocations. The recent EPF arrangements expand on this approach. The federal government decided to provide not only tax-point transfers to accommodate more nearly the provincial expenditure priorities, but also to provide additional per capita cash transfers in an effort to achieve greater equality of service among the provinces.

In view of varying concerns about rising health care costs and about the maintenance and improvement of health care, it is useful to examine, within the context of a study on fiscal federalism, what has been achieved over the years through public funding of this major social program.

The objective of our analysis is to determine:

– to what extent there are substantial differences in per capita health services;

– whether the provincial differences, if any, have narrowed or widened over the years; and,

– whether provincial differences in the provision of health services might be decreased without increasing the overall resources devoted to obtaining greater equality of health care.

The analysis does not cover all aspects of provincial health care; instead, it concentrates on selected areas that are covered by publicly funded insurance programs in all provinces. The chapter begins with some international comparisons of health care costs, then proceeds with a review of the historical trends in Canadian health services, and finally focuses on provincial developments. It is an attempt to trace in an exploratory way, under a set of restrictive assumptions and data limitations, the major factors contributing to some of the provincial disparities in health expenditures and services.

International Comparisons

Much of the concern in Canada with respect to health care in recent years has centred on its ever-rising cost. An insatiable demand seems at times to be outstripping supply despite a vast increase in the share of national income going to such services. So it

is, throughout the rich industrialized world. In almost every country, health spending is eating further and further into national income, with no corresponding rise in the standards of health or quality of medical services.[3]

The rise in health expenditures has become a topic of growing concern at international meetings, and over the years reasonably comparable estimates have been developed. Table 7-1, for example, shows what proportion of gross domestic product (GDP) was devoted to health care in ten countries at two points in time. During the early 1960s, the average proportion was 4.5 per cent of GDP; but, over the years, the cost of health care increased more rapidly than GDP, and by the mid-1970s the average proportion had reached 6.3 per cent. At the outset of this period, many analysts expected that health expenditures would, on average, absorb one additional percentage point of GDP per decade.[4] As it turned out, this estimate was overly conservative. Taken together, the ten countries exceeded that estimate.

Table 7-1

Health Care Expenditures as a Proportion of Gross Domestic Product,[1] Selected Countries, 1962 and 1974

	1962[2]	1974[2]
	(Per cent)	
Canada	5.2	6.8
United States	5.0	7.4
Australia	4.8	6.2
France	4.7	6.9
Sweden	4.7	7.3
Netherlands	4.5	7.3
New Zealand	4.3	5.5
United Kingdom	3.9	5.0
Switzerland	3.8	5.0
Finland	3.8	5.6
Unweighted average (10 countries)	4.5	6.3

1 Estimates are based on GDP trends at current prices.
2 Or nearest year for which data are available.
SOURCE Estimates by the Economic Council of Canada, based on the Organisation for Economic Co-operation and Development, *Public Expenditures on Health*, Studies in Resource Allocation, Series No. 4 (Paris: OECD, July 1977).

The remarkable rise in health care expenditures has come about, in part at least, because governments of most countries have made it their policy to reduce inequality of access to medical and hospital care. In the ten countries included in the international comparison above, for example, the share of *public* health expenditures grew about 25 per cent faster than that of *total* health expenditures. While this might suggest that additional government funding of health services contributed in a substantial way to the rapid growth in total health costs, such a conclusion is not strongly confirmed by international comparisons. The United States, for example, had the highest rate of growth in its public health expenditure share, while France had an average rate of growth. Yet both countries experienced about the same growth in total health expenditure shares (Appendix Table D-1).

Similarly, in the case of Canada, the link between public and total health expenditures was also not very strong. Canada's growth in the *public* expenditure share ranked among the highest – primarily because of the introduction of medical insurance during the late 1960s – but its growth in the *total* expenditure share ranked among the lowest.[5] Thus Canada did well by international comparison and, in spite of a more rapid expansion of public funding, managed to keep the growth of health expenditures in line with the more conservative expectations of earlier years.

If public funding was not the real culprit in rising health expenditures, other factors must have been involved. And there appear to have been many. Members of an affluent society are less prepared to suffer minor ailments without drugs or other medical aid. Medical research continues to push out the frontiers of curable disease, developing new diagnostic techniques with bigger price tags (like the CAT scanner)[6] and finding new cures for old diseases (such as heart valve implants). In extending the average life span, health services tend to become the victims of their own success. The elderly whose lives they save require more routine medical care than the young, so that a small increase in their numbers means a large increase in health care costs. Health insurance programs make their services more accessible, especially to the elderly and the low-income people. At the same time, people – rich and poor – are squandering away part of the gains in health by inflicting upon themselves the diseases of a more affluent society, thereby accentuating the problems arising from sedentary work and lack of exercise. As well, smoking and drinking, environmental pollution, and even social change, add their toll.[7]

This listing of cost factors is not based on a quantitative analysis of international experience. It merely underlines the fact that many elements – not a particular one – have contributed to the rise in health expenditures. Under a market-based free enterprise system, we would expect all these factors to come into play, with the ultimate result that incomes and prices align demand and supply. Under government-instituted "free access" to the system, as in the case of publicly funded health care, income and price constraints formerly imposed by the market place are

now replaced by other constraints imposed by government. In the long run, responsible government will attempt to keep the costs of such programs within the range afforded by national income and tax revenue and, at the same time, attempt to maintain and possibly improve upon the quality of service. In the short run, particularly at times of economic stress, concerns are likely to arise because the gap between what the country can afford and what consumers and producers of health services would like to have is difficult to bridge.

Canadian Historical Experience

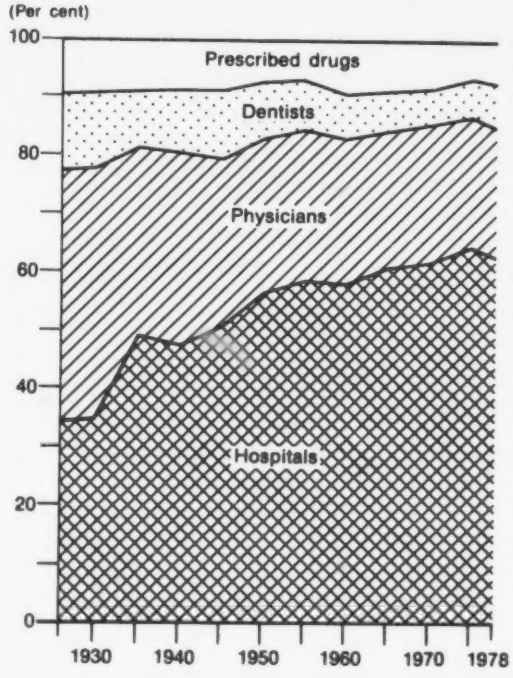
Analysis of Canadian expenditures on medical care and health services during the period 1926-76 shows that prior to the introduction of public health insurance the consumer response to changes in incomes was strong: for every 1 per cent change in personal incomes, health expenditures changed by 2 per cent. Analysis indicates that this response weakened over the years and by the late 1950s the same 1 per cent change in personal incomes resulted in a change in health expenditures of less than 2 per cent. Subsequently, other factors gained in significance, particularly the introduction of medical insurance, the changing age distribution of the population, and government funding.[8] Thus income has had a pervasive impact on health expenditures. In earlier years it was primarily the impact of changes in personal incomes; in later years it was that of public funding and national income. This shift in emphasis reflects, no doubt, the widespread recognition that a better living standard is not just a function of higher per capita incomes, but also that of more comprehensive protection for the individual person against unforeseen impairment of health.[9]

Over the 50 years from the mid-1920s to the mid-1970s, Canadians increased their spending on health care through private and public funding more than twentyfold, from an estimated $25 per capita in 1926 to $600 in 1976. Expenditures on other consumer goods and services rose too, but expenditures on health care increased at a faster rate and thereby contributed to the overall shift of the economy from goods to services.

Throughout this period of expansion, hospital and physicians' services absorbed the largest share of health outlays. In Chart 7-1 there are four major types of health expenditures. As part of these four, the combined expenditures on hospital and physicians' services remained fairly stable, but individually they changed substantially over the years. Whereas in the mid-1920s expenditures on physicians' services accounted for about 45 per cent and hospital services for about 35 per cent of these outlays, today they account for less than 25 per cent and for more than 60 per cent, respectively. This implies that hospital expenditures have risen much faster than expenditures on physicians' services (Chart 7-1).

Chart 7-1

Distribution of Major Expenditures on Personal Health Care, by Type of Expenditure, Canada, 1926/78[1]



1 The estimates underlying this chart are only approximate. They do not cover all personal health care expenditures and do not include, for example, paramedical services, prosthetic appliances, and non-prescribed drugs.

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada; and the *Report of the Royal Commission on Health Services*, vol. 1 (Ottawa: Queen's Printer, 1964). See also S. Andreopoulos, ed., "National Health Insurance: Can We Learn from Canada?" (New York: Wiley, 1975), Chapter 3 by R. G. Evans.

Hospital expenditures and physicians' services have not grown independently of each other. The consumption of almost all hospital services is dependent upon physicians' services. Their services, in turn, depend on the number of physicians and the output per physician. Compared with the Depression years, the number of physicians per capita has nearly doubled (Table 7-2). The character of their practice has changed. Office and hospital calls have replaced time-consuming house calls. To some extent, solo practice has given way to clinics specializing in

diagnostic and therapeutic services. Access to hospital facilities and expensive equipment has been greatly improved. As a result, physicians can see more patients per year, provide more diagnostic and therapeutic services, and extend their medical services to a larger clientele.

Table 7-2

Life Expectancy, and Selected Health Resources, Canada, Selected Years, 1931-76

	Life expectancy at birth		Active civilian physicians[1]	Registered nurses	Rated hospital-bed capacity[2]
	Male	Female			
	(Years)		(Per 100,000 population)		
1931	60	62	97	..	395[3]
1941	63	66	93	242	463
1951	66	71	102	314	510
1961	68	74	117	430	551
1971	69	76	152	671	641
1976	70	77	174	775	719

1 Including interns and resident physicians.
2 Rated hospital-bed capacity refers to general and allied public hospitals only.
3 Rated bed capacity for the year 1932.
SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada; the Royal Commission on Health Services; and Health and Welfare Canada.

With the rise in health expenditures has come a definite improvement in the health of Canadians. It would be very difficult to measure the real benefit of these expenditures if it meant evaluating their impact on the status of the country's health, especially if health is defined very broadly. The World Health Organization, for example, defines health as "a state of complete physical, mental and social well-being and not just the absence of disease and infirmity."[10] It is not possible at present to measure all these dimensions of health, but certain indicators are available.

One of the indicators is life expectancy. Although this indicator does not take into account the incidence of non-fatal diseases, it is known to be closely associated with many forms of morbidity and debility and is thought to provide a good indication of the range and intensity of health problems in a country. Indeed, for the purpose of international comparisons the World Bank considers it to be the most reliable indicator of health status available.[11] A link exists between life expectancy and health services. Among 75 countries, for example, roughly four-fifths of the international variations in life expectancy are associated with access to physicians, nurses, and hospitals. With "diminishing returns" to additional inputs, however, a point is reached where further increases yield little or no gains. This critical point appears to be in the neighbourhood of 150 physicians per 100,000 people. If realistic, it would put Canada, with over 170 physicians per 100,000 people, beyond this point.[12]

Over the years, life expectancy in Canada has increased along with the expansion of health services. The gains in life expectancy, however, have not been proportional to the additional services because of diminishing returns. During the two decades from 1931 to 1951, for example, health services expanded slowly, and the life expectancy of males increased from 60 to 66 years and that of females from 62 to 71 years. Over the following two decades from 1951 to 1971, health services expanded more rapidly – that is, the number of physicians per capita increased by 50 per cent – but life expectancy advanced at only half the rate of the earlier period (Table 7-2).

Similarly, the provincial variations in life expectancy are not directly proportional to the provincial variations in available health services. Since provincial estimates of life expectancy are only available for census years and not annually, an alternative and more sensitive health indicator was used for analysis. It is well known that much of the improvement in life expectancy over the past 50 years has come about because of the lower rate of infant mortality. Provincial records of infant mortality have been kept for many years, and these have been examined in relation to the numbers of provincial physicians, nurses, and hospital beds per capita. Again, the association is not very strong. Although statistical analysis shows that the three sets of numbers for physicians, nurses, and hospital beds are correlated with infant mortality, together they account for only about one-third of the provincial variations. That leaves the larger proportion – two-thirds of the provincial variations – unexplained.[13] Some of the latter might be related to provincial variations in urban stress, population density, accident rates, and perhaps other environmental conditions.

These results do not lend convincing support to the proposition that a further substantial expansion of existing health services would further extend life expectancy in Canada. They are not out of line with the earlier finding, based on international comparisons, implying that returns to additional health services approached zero in some of the highly industrialized countries. Nor do they run counter to the mainstream of the literature of health economics. At the same time, it is known that not all additional health services are directed at extending the average life span. In part, at least, they are aimed at improving the quality of life. It is not known, at present, how

much of this quality improvement translates directly into longer life and how much of it simply makes life more livable, especially for the elderly.

Since the provincial variations in status of health, as measured here, are not very closely associated with provincial variations in the delivery of health services, it is of special interest in the context of this chapter to determine:

– what health services are being provided in each province;

– how much they cost per capita;

– why the costs differ from one province to the next; and

– to what extent both costs and services have changed over the years.

It is of some importance to attempt to determine why provincial health expenditures vary so much while provincial life expectancy varies so little. As shown in Table 7-3, per capita health expenditures vary among the provinces by as much as one-third, hospital expenditures vary by one-half, and expenditures on physicians' services vary even more; life expectancy, however, is nearly the same in all provinces.

More specifically, in the context of this study of federal-provincial fiscal arrangements, it is important to determine whether provincial variations in health expenditures result from variations in health services or from other factors. Conceivably, all the variations in expenditures could simply be due to provincial variations in the nominal cost of service, with the result that, measured in real dollars, the service per capita is the same in all provinces. The first task, therefore, is to determine what kind of health services the provinces provide. Judging by one or two indicators, the immediate impression is that provincial disparities in health services are real and that, in some cases at least, they have existed for many years. Over the past five decades, for example, rated hospital-bed capacity per capita was generally below the national average in the Atlantic provinces and above average in the Prairie provinces. The number of active civilian physicians was above average in Ontario and British Columbia and below average in most other provinces (Table 7-4).

Indicators of this type are rather vague and relate more nearly to capacity than actual use. Rated bed capacity refers to the number of beds and cribs that a hospital is designed to accommodate on the basis of floor area.[14] Active civilian physicians include not only those who practise their medical profession for fee payment, but also those who work in government administration, medical research, and other areas.[15] More precise measures of hospital use and physi-

Table 7-3

Provincial Variations in Life Expectancy and in Expenditures per Capita on Health Care, Hospitals, and Physicians' Services, Canada, 1976

	Relationship to national average (Canada = 100)				
	Life expectancy		Expenditures per capita[1]		
	Male	Female	Health[2]	Hospitals[3]	Physicians
			(Per cent)		
Newfoundland	101	100	76	75	58
Prince Edward Island	99	101	79	79	69
Nova Scotia	99	100	94	91	87
New Brunswick	99	100	77	82	60
Quebec	98	99	101	114	95
Ontario	101	100	104	100	107
Manitoba	101	101	100	105	88
Saskatchewan	101	101	94	90	79
Alberta	101	101	100	93	102
British Columbia	101	101	102	87	125
	(Years)			(Dollars)	
National average[4]	70	77	611.85	345.90	91.34

1 Includes both public and private expenditures.
2 Includes expenditures on hospitals and nursing homes, as well as on physicians' services, dentists' services, drugs, appliances, and other.
3 Hospitals and nursing homes.
4 Also takes into consideration the Yukon and the Northwest Territories.
SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada and from Health and Welfare Canada.

cians' services are presented below. This is done for hospital services first and then for physicians' services. In doing so, attention is focused on the period over the past two decades when public health insurance programs were in force.

Table 7-4

Provincial Variations in Rated Hospital-Bed Capacity and in Active Civilian Physicians, per Capita, Canada, Selected Years, 1931-75

	Relationship to national average (Canada = 100)			
	1931	1951	1971	1975
	(Per cent)			
Rated hospital-bed capacity:[1]				
Newfoundland	...	93	90	81
Prince Edward Island	51	124	105	93
Nova Scotia	76	101	95	95
New Brunswick	82	79	106	94
Quebec	82	92	95	104
Ontario	100	91	98	92
Manitoba	113	123	100	100
Saskatchewan	91	135	122	124
Alberta	137	117	142	122
British Columbia	163	122	92	97
Active civilian physicians:[2]				
Newfoundland	...	39	67	75
Prince Edward Island	74	73	69	70
Nova Scotia	90	89	94	92
New Brunswick	68	68	69	71
Quebec	99	99	96	99
Ontario	119	114	107	107
Manitoba	98	105	100	99
Saskatchewan	65	76	86	87
Alberta	82	87	99	89
British Columbia	109	115	117	112

1 Estimates for 1931 are based on 1932 data. The data on hospital-bed capacity for 1975 pertain to general and allied public hospitals and tuberculosis sanatoria only. They exclude mental hospitals and homes for special care; hence they are not quite comparable to the hospital expenditure estimates in Table 7-3, which include all hospitals and nursing homes.

2 Estimates for 1971 and 1975 exclude intern and resident physicians.

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada; the Royal Commission on Health Services; and Health and Welfare Canada.

The Development of Health Insurance Programs

Canadian hospital insurance and medical insurance programs were introduced over a period of years. Saskatchewan pioneered with a provincial hospital insurance program in 1946. By the end of another decade, interest in health insurance had grown to the point where many provinces were pressing the federal government for action. The National Hospital Insurance Program began in 1958 when five provinces – Newfoundland, Manitoba, Saskatchewan, Alberta, and British Columbia – had insurance programs in operation that were eligible for federal cost sharing. By 1961, the population of all ten provinces became entitled to the same basic hospital care benefits that were prescribed in the Hospital Insurance Act. The medical insurance program, designed to cover all medical services rendered by physicians, was enacted by Parliament in 1966. Saskatchewan and British Columbia entered into the medical care program in 1968, and by 1971 all the other provinces had joined.

Contrary to some predictions at the time, there was no great run on hospitals. In fact, after the National Hospital Insurance Program came into force in 1958, the annual rates of increase in patient-days per 1,000 population declined. From 1953 to 1958, the rate of growth had been 2 per cent; from 1958 to 1963 it was only 1.6 per cent.[16] In part, this was a result of the program's design.[17] Based on the prior experience of Saskatchewan and British Columbia, the National Hospital Insurance Program was preceded by a substantial expansion of hospital facilities and personnel. This expansion was facilitated by the National Health Grants Program of the late 1940s and 1950s, which alleviated some of the shortages dating back to the years of the Great Depression and the Second World War. Similarly, the medical care program was accompanied by an expansion in the number of physicians and other health personnel. It occurred during the years 1967 to 1971, either before, or at the same time as, the various provinces implemented their medical care programs. In response partly to the increase in the number of physicians and partly to the greater use of hospital facilities by the physicians, hospital costs increased dramatically.[18] In the three years 1966, 1967, and 1968, the average rate of increase was 17 per cent; in 1968 it was more than 20 per cent.[19]

By 1969, the escalation of hospital costs had become a major problem, and a task force was appointed to look into it.[20] At a conference held in December 1970, the federal Minister of Health and Welfare and his provincial counterparts agreed that steps needed to be taken to contain the rise in health care costs and that a comprehensive review of the existing cost-sharing arrangements was both timely and appropriate. It was proposed that the existing federal-provincial cost-sharing arrangements be replaced, in part at least, by per capita payments.[21] In 1977, the federal government introduced Established Programs Financing, and it was put into force as part of the larger Fiscal Arrangements Act. Based partly on per capita cash transfers and partly on tax-point transfers, it was to provide the provinces with

an incentive to keep the cost of health care programs down, to make for greater equality among provinces in per capita terms, to maintain the standards achieved, and to facilitate their improvement by allowing greater flexibility.[22]

The per capita operating costs of general and allied public hospitals – the largest item of health care expenditures – rose from 1961 to 1978 at an average annual rate of 14 per cent. This rise was partly the result of providing more and better services and partly the result of price inflation. To see what proportion resulted from each factor, total operating costs must be broken down into individual elements. First of all, note that per capita operating costs can be expressed as the product of two factors: patient-days per capita and cost per patient-day. In 1975, for example, Canadians spent 2.02 days per capita in general and allied public hospitals. At an operating cost of $107.28 per patient-day, this amounted to a cost of $216.71 per capita. Over the years, both increased. Patient-days increased from 1.6 days per capita in 1961 to 2.2 days in 1978, or by approximately 40 per cent. Costs per patient-day increased from roughly $20 in 1961 to $140 in 1978, or by more than 500 per cent (Table 7-5).

At this stage of the analysis it could be determined how much of the increase in the number of patient-days per capita was attributable to changes in the age distribution of the population, changes in the hospital admission rates of individual age groups, and changes in the length of stay per admission. Because our estimates in Table 7-5 clearly indicate, however, that the change in the number of patient-days per capita was relatively small compared with the rise in hospital operating costs after 1961, we turn directly to this more important cost factor.

The operating costs per patient-day of general and allied hospitals accounted for more than 90 per cent of the rise in total costs. This increase in operating costs resulted from three major factors: 1/ labour hours per patient-day; 2/ wage rates per hour; and 3/ other hospital operating expenditures. In turn, each of these three factors was affected by cost changes in several hospital departments and numerous activities. In nursing, for example, the increase was caused mostly by cost changes in the emergency unit, the surgical suite, the obstetrical suite, inpatient care, central supply, and nursing administration. In diagnostic and therapeutic treatment, it came from radiology, lab services, pharmaceutical treat-

Table 7-5

Operating Costs per Capita, General and Allied Public Hospitals,[1] Canada, 1961-78

	Patient-days per capita	Operating costs per patient-day	Operating costs per capita (col. 1 × col. 2)
	(Days)	(Current dollars)	
1961	1.59	21.63	34.39
1962	1.60	24.02	38.43
1963	1.74	24.56	42.73
1964	1.79	26.55	47.52
1965	1.80	29.22	52.60
1966	1.83	32.65	59.75
1967	1.80	38.14	68.65
1968	1.88	42.06	79.07
1969	1.91	51.18	97.75
1970	1.96	56.29	110.33
1971	2.01	60.60	121.81
1972	1.99	67.17	133.67
1973	1.95	76.14	148.47
1974	2.00	89.89	179.78
1975	2.02	107.28	216.71
1976	2.16	118.38	255.70
1977	2.21	126.75	280.12
1978	2.17	142.10	308.36

1 Estimates of operating costs in this table and all subsequent tables pertain only to general and allied public hospitals and not to private and federal hospitals. The latter account for only a small proportion of total expenditures. Data relating to them are incomplete and would not have permitted a detailed analysis of provincial disparities.

Exclusion of the private and federal hospitals would not alter the conclusion in the text that for the period 1961 to 1978 relative changes in hospital days per capita were small compared with the changes in operating costs per patient-day. Had private and federal hospitals been included, the changes in patient-days per capita would have been even smaller.

Also, the estimates of patient-days, in this table and in all subsequent references, pertain not only to hospital "in-patients," but they have been adjusted to cover hospital "out-patients" as well.

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada and from Health and Welfare Canada.

Table 7-6

Contribution of Labour Requirements, Wage Rates, and Other Operating Expenditures to Annual Changes in Hospital Costs per Patient-Day, Canada, 1961-78

	Contribution[1]			
	Labour hours per patient-day	Wage rate per hour	Other operating expenditures	Average annual change
	(Percentage points)			(Per cent)
1961-65	1.5	4.1	2.3	7.9
1965-70	0.7	9.5	3.9	14.1
1970-75	0.8	8.8	4.3	13.9
1975-78	-1.5	11.5	-0.2	9.8
1961-78	0.5	8.4	2.9	11.8

1 The percentage point contributions add up to the average annual percentage change.

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

ment, physical medicine, rehabilitation, and outpatient treatment. In education, it derived from medical and nursing education; in administration and support, from dietetics, laundry, linen, medical records, plant operation, and hospital administration. Taking into account the changes in the cost of each of the three factors referred to above, about two-thirds of the 1961-78 rise (i.e. 8.4 percentage points of the 11.8 per cent average annual rate of change) in hospital operating costs per patient-day stemmed from higher wage rates per hour; one-quarter, from the additional operating expenditures (including food and all other supplies); and the small remainder, from additional working hours per patient-day, as shown in Table 7-6.

Provincial Variations in Health Services

Better access to health services for all Canadians, regardless of income or province of residence, is the central objective of government-funded health insurance. Applying estimation procedures similar to those used above, it is possible to determine the sources of provincial variations in health expenditures, the extent to which there may be differences in the relative levels of service provided by the various provinces, and whether provincial disparities have narrowed or widened over the years.

Hospital Operating Expenditures

Over the period that publicly funded insurance has been in effect, provincial variations in hospital expenditures have narrowed very little. Throughout the period, provincial per capita expenditures have been below the national average in the Atlantic provinces, mostly above average in Quebec and Ontario, and close to, or slightly below, average in the western provinces. In the early 1960s, for example, per capita operating expenditures of public hospitals ranged from a low of 66 per cent of the Canadian average in Newfoundland to a high of 110 per cent in Ontario. During the years 1967 to 1975, this range narrowed by a few percentage points, but then it widened again; in fact, from 1976 to 1978, it was wider than in the early years of the insurance program. At the same time, the order in which the provinces ranked also changed, as shown in Table 7-7.

These patterns of provincial variations in hospital expenditures, as well as changes in the patterns, can be attributed to a variety of factors. Two of the major factors are provincial variations in hospital days per capita and in costs per patient-day. Both have contributed in roughly equal proportions to the provincial disparities in per capita expenditures. During the years 1961 to 1965, for example, the per capita hospital operating expenditures in Newfoundland amounted to only 66 per cent of the Canadian average (Table 7-7). This gap of 34 percentage points resulted mostly from fewer patient-days per capita (33 percentage points), not from lower operating costs per patient-day (1 percentage point), as indicated in Table 7-8. The corresponding 29 percentage-point gap between Prince Edward Island and the Canadian average, by contrast, was not the result of fewer patient-days per capita, but of lower costs per patient-day.

Table 7-7

Provincial Variations in Operating Expenditures per Capita, General and Allied Public Hospitals, Canada, 1961-78

	Relationship to national average (Canada = 100)			
	1961-65	1966-70	1971-75	1976-78
	(Per cent)			
Newfoundland	-34	-20	-15	-9
Prince Edward Island	-29	-33	-34	-34
Nova Scotia	-12	-10	-9	-8
New Brunswick	-2	-12	-7	-12
Quebec	-5	6	5	17
Ontario	10	5	4	-4
Manitoba	-2	-10	-7	-11
Saskatchewan	9	-8	-12	-12
Alberta	-2	1	-	-5
British Columbia	-4	-14	-10	-8

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

Over the past two decades, patient-days per capita and costs per patient-day have changed, but some of the regional characteristics have remained. In the Atlantic provinces, lower costs per patient-day and fewer patient-days per capita kept hospital operating costs below the national average. In Quebec, fewer patient-days lowered the operating costs, but higher costs per patient-day more than outweighed the former factor. In Ontario, costs remained fairly close to the national average. In the West, more patient-days added to costs, while lower costs per patient-day reduced them. With a relative decline in patient-days per capita, especially in Saskatchewan, the western provinces have managed to keep their overall cost at, or below, the national average (Table 7-8).

Striking changes have occurred over the past few years, not so much in the overall cost of hospital operation as in the provincial variations in patient-days per capita and in costs per patient-day. The break with the past is most noticeable in the case of Quebec. During the period 1976-78, patient-days per

Table 7-8

Contribution of Patient-Days per Capita and Cost per Patient-Day to Provincial Variations in Operating Expenditures, General and Allied Public Hospitals, Canada, 1961-78

	Contribution[1]			
	1961-65	1966-70	1971-75	1976-78
	(Percentage points)			
Patient-days per capita:				
Newfoundland	-33	-9	-13	-34
Prince Edward Island	3	3	-2	-12
Nova Scotia	-7	-3	-5	-24
New Brunswick	1	3	3	-9
Quebec	-16	-14	-10	19
Ontario	7	3	-	-9
Manitoba	8	4	2	-8
Saskatchewan	35	23	20	13
Alberta	16	26	29	-
British Columbia	-1	-9	-5	-3
Cost per patient-day:				
Newfoundland	-1	-11	-2	25
Prince Edward Island	-32	-36	-32	-22
Nova Scotia	-5	-7	-4	16
New Brunswick	-3	-15	-10	-3
Quebec	11	20	15	-2
Ontario	3	2	4	5
Manitoba	-10	-14	-9	-3
Saskatchewan	-26	-31	-32	-25
Alberta	-18	-25	-29	-5
British Columbia	-3	-5	-5	-5

1 The estimated percentage point contributions of both "patient-days per capita" and "cost per patient-day" add up to the variations in Table 7-7.

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

capita rose sharply in Quebec and declined in most other provinces. By contrast, the cost per patient-day dropped in Quebec and rose in most other provinces. While it is not known how much of this most recent change has derived from provincial variations in range and quality of services, or from variations in statistical coverage, some first indications of the sources of change can be gained from a further analysis of patient-days per capita and costs per patient-day (Table 7-8).

Patient-Days per Capita

Provincial variations in patient-days per capita can be attributed to three factors: the age distribution of the population; hospital admission rates; and the length of hospital stay. The age distribution of the population is an important cost factor because, provincially, it affects hospital admission rates and the length of hospital stay. In 1977, for example, 7 per cent of children 5 to 14 years old were admitted to hospital and stayed, on average, for 5 days. In the same year, 28 per cent of the elderly 65 to 74 years old were admitted to hospital and stayed for 18 days. Because of such age effects, the "younger" populations of Newfoundland, Quebec, and Alberta made for lower hospital operating costs per capita, while the "older" populations of Prince Edward Island, Manitoba, Saskatchewan, and British Columbia made for higher costs. As shown in Table 7-9, provincial variations in age distribution account for up to 23 percentage points of the variations in patient-days per capita. These percentage variations have remained very stable over the years. Important as the provincial age distribution is as a factor contributing to provincial variations in patient-days per capita, it is not recognized by the existing insurance system.

Table 7-9

Contribution of the Provincial Age Distribution to Provincial Variations in Patient-Days per Capita, General and Allied Public Hospitals, Canada, 1961-77

	Contribution[1]			
	1961-65	1966-70	1971-75	1976-77
	(Percentage points)			
Newfoundland	-8	-9	-10	-12
Prince Edward Island	12	11	9	9
Nova Scotia	4	5	3	3
New Brunswick	-	-	-	-
Quebec	-9	-9	-7	-7
Ontario	3	2	2	2
Manitoba	7	8	8	8
Saskatchewan	9	10	12	11
Alberta	-4	-4	-6	-7
British Columbia	11	8	6	6

1 The percentage point estimates in this table show by how much the patient-days per capita vary among the provinces because of provincial variations in the age distribution of the population. Since data for the age distribution of hospital patients are not yet available for the year 1978, the analysis covers only the period 1961-77.

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

Traditionally, hospital admission rates have been relatively low in the provinces of Ontario and Quebec and even lower in some of the Atlantic provinces, but they have been very high in the Prairie provinces. Correspondingly, their contribution to provincial variations in patient-days per capita ranged, during the period 1961-65, from −26 per cent in Newfoundland to +32 per cent in Saskatchewan. Over the years, admission rates have risen in the Atlantic provinces, remained at very high levels in Saskatchewan and Alberta, and fallen off in Quebec and Manitoba. These trends have continued to remain fairly stable over the years (Appendix Table D-2).

Since they are standardized for provincial variations in age distribution, they are not related to age. Statistics show, however, that on a per capita basis far more surgical operations are performed in some provinces than in others. It is not clear why this should be so. Nor is it clear why hospital admission rates should be so much higher in some provinces than in others.

The pattern of provincial variations in length of hospital stay is even more striking. At the beginning of the period, hospital stays were longer in Ontario and Quebec, and shorter in the East and West. Over the years, hospital stays have been shortened in all provinces but Quebec. In that province the length of stay has actually increased and, today, is longer than in any other province. With a much lower rate of hospital admission per 1,000 population and much longer hospital stays, Quebec's 1976/77 pattern differs from that of all other provinces (Appendix Table D-2). This break in the provincial pattern is important, and we shall come back to it later.

Costs per Patient-Day

Provincial variations in costs per patient-day have contributed nearly as much to the provincial variations in hospital operating expenditures as patient-days per capita; in some cases, even more. In Prince Edward Island, for example, per capita hospital operating costs have been about one-third below the national average, and lower costs per patient-day have accounted for most of the difference. In Saskatchewan and Alberta, costs per patient-day have also been much lower and have more than compensated for the higher cost resulting from a greater number of patient-days. In Quebec, however, greater costs per patient-day contributed to higher hospital costs per capita in most of the years (Table 7-8).

The range in the provincial variations of costs per patient-day has not narrowed over the years, nor have the total provincial contributions to variations in per capita costs; however, the underlying configuration has changed. For many years, costs per patient-day have been above the national average in the central region. They have accounted for up to 5 per cent higher costs per capita in Ontario and up to 20 per cent higher costs in Quebec. They were much lower in the East and West, and in some of the years they resulted in per capita operating expenditures that were 25 to 35 per cent lower. Since 1975, however, this pattern has changed. Costs per patient-day have dropped sharply in Quebec and risen in most other provinces, especially in some of the Atlantic provinces (Table 7-8).

These provincial variations in costs per patient-day can be attributed to provincial differences in three factors: labour hours per patient-day; wage rates per hour; and other operating expenditures. Labour hours per patient-day have been consistently below the national average in Prince Edward Island, Saskatchewan, and Alberta. Wage rates per hour have been below average in the Atlantic region and the Prairie provinces. And other operating expenditures have been below average in Prince Edward Island and in the three westernmost provinces. By contrast, all three cost factors have been near, or above, average in Ontario and Quebec during most of the years. Hospital operating costs per patient-day have varied accordingly (Table 7-10).

The rather striking changes between the provincial variations in costs per patient-day from earlier years have been caused mostly by changes in labour hours per patient-day and not so much by changes in wage rates per hour or other operating expenditures. During the years 1976-78, labour hours per patient-day rose dramatically in Newfoundland and Nova Scotia and declined in Quebec.

The search for the underlying causes of these recent changes can be carried further. It can be shown, for example, that the drop in labour hours per patient-day and its contribution to lower costs per patient-day in Quebec have been the result of a reduction in staff, relative to the Canadian average, in three hospital departments – nursing, diagnostic and therapeutic services, and administration. Conversely, the increase in labour hours and costs in Nova Scotia has resulted from an expansion of staff in the same three departments. In the case of Newfoundland, however, the expansion in the three departments was enlarged by an additional increase in labour hours devoted to medical and nursing education, as shown in Appendix Table D-3.

Similar estimation procedures can be applied to determine how much each of the major hospital departments has contributed to the provincial disparities in wage rates and other expenditures (Appendix Tables D-4 and D-5). On the basis of available statistics, it would be possible to trace provincial variations in hospital operating costs to numerous activities within each province – for example, to emergency and other ambulatory care, the surgical suite, or the obstetrical suite in nursing; to the laboratory, radiology, or special clinics in diagnostic and therapeutic services; to dietetics, laundry, or medical records in administration. This would make for even greater precision in measuring the provincial disparities and changes in hospital costs and services. Nevertheless, it would still not tell the full story.

Table 7-10

Contribution of Labour Hours, Wage Rates, and Other Operating Expenditures to Provincial Variations in Costs per Patient-Day, General and Allied Public Hospitals, Canada, 1961-78

		Contribution			Deviation from national total
		Labour hours per patient-day	Wage rate per hour	Other operating expenditures	
		(Percentage points)			(Per cent)
Newfoundland	1961-65	-11	-1	13	1
	1966-70	-10	-8	6	-12
	1971-75	6	-13	5	-2
	1976-78	35	-20	15	30
Prince Edward Island	1961-65	-21	-7	-4	-32
	1966-70	-25	-4	-6	-35
	1971-75	-10	-15	-7	-32
	1976-78	-3	-20	-1	-24
Nova Scotia	1961-65	1	-11	5	-5
	1966-70	-	-12	4	-8
	1971-75	3	-10	3	-4
	1976-78	26	-18	10	18
New Brunswick	1961-65	4	-11	4	-3
	1966-70	-3	-11	-1	-15
	1971-75	-3	-7	-	-10
	1976-78	1	-9	5	-3
Quebec	1961-65	6	3	3	12
	1966-70	11	8	2	21
	1971-75	8	4	4	16
	1976-78	-4	3	-1	-2
Ontario	1961-65	1	1	-	2
	1966-70	1	-	1	2
	1971-75	1	2	1	4
	1976-78	1	4	1	6
Manitoba	1961-65	-	-6	-3	-9
	1966-70	-2	-10	-2	-14
	1971-75	2	-10	-	-8
	1976-78	7	-11	1	-3
Saskatchewan	1961-65	-14	-2	-6	-22
	1966-70	-15	-6	-6	-27
	1971-75	-12	-10	-7	-29
	1976-78	-13	-8	-3	-24
Alberta	1961-65	-8	-4	-5	-17
	1966-70	-11	-6	-5	-22
	1971-75	-13	-5	-7	-25
	1976-78	-1	-3	-	-4
British Columbia	1961-65	-6	6	-3	-3
	1966-70	-7	5	-3	-5
	1971-75	-9	10	-5	-4
	1976-78	-7	7	-4	-4

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

Mental Hospitals and Other Institutions

The preceding analysis did not include mental hospitals and other institutions. They were excluded because under the Hospital and Diagnostic Services Act of the 1960s and early 1970s mental hospitals, as well as certain other institutions, were not covered by federal contributions to provincial health care.[23] The enactment of Established Programs Financing in 1977, however, provided the provinces with greater flexibility in this area and, partly as a result of this, they expanded their coverage to mental hospitals, nursing homes, extended and ambulatory care, and certain other areas.

Very likely, therefore, the closer integration of some of the mental hospitals and other institutions of extended care has contributed to the recent break in the long-term trends of general and allied hospital expenditures. In this process, mental hospitals have

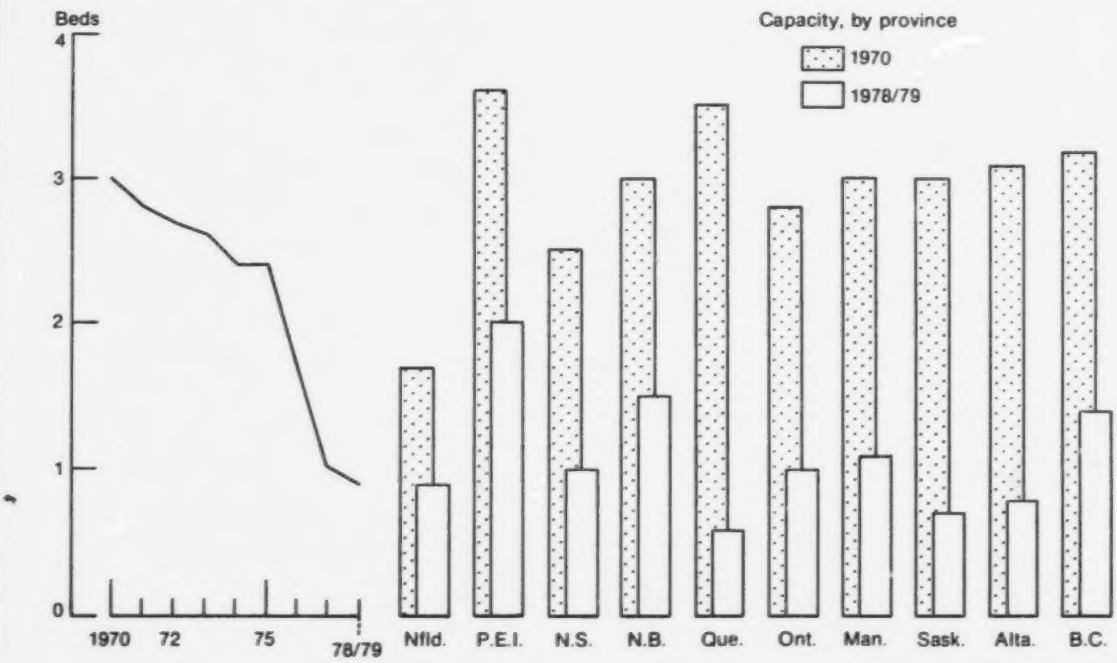
become more closely associated with both the general and allied hospitals, as well as other special-care facilities. As a result of this policy, at least in part, the rated bed capacity of mental institutions has been reduced all across Canada. Although this pattern of change has emerged over the past two decades, the anticipation and introduction of Established Programs Financing appears to have accelerated the trend in most provinces. It also appears that Quebec moved faster in this direction than most other provinces (Chart 7-2).

Typically, mental patients stay longer in hospital than other patients. In 1977, for example, they stayed, on average, for more than 100 days, while other patients stayed for only 11 days. The cost per patient-day was also lower in mental institutions than in other hospitals; in 1977 it was $86 compared with $140. A closer integration of mental institutions with general and allied hospitals should have the effect, therefore, of lengthening the average duration of stay and lowering the cost per patient-day. If Quebec had integrated its mental institutions more rapidly with general and allied hospitals, that would have explained why, in comparison with other provinces, its patient-days per capita so sharply increased and its cost per patient-day diminished. Combining the statistics of general and allied hospitals with those of mental institutions should cause provincial disparities in per capita hospital operating expenditures to narrow. This is actually what happens. The inclusion of mental institutions reduces the provincial differences in operating expenditures significantly – between Quebec and Ontario, for example, from 21 to 15 percentage points and between Quebec and Prince Edward Island from 51 to 40 percentage points (Appendix Table D-6). While this sort of adjustment helps explain why, since 1975, provincial disparities in hospital expenditures per capita have widened, it still leaves much of the divergence unexplained. Quite possibly the unexplained remainder is related to provincial variations in extended health care.

Chart 7-2

Rated Bed Capacity in Mental Institutions, Canada, by Province, 1970 to 1978/79

Rated beds per 1,000 population



SOURCE Statistics Canada, *Mental Health Statistics*, vol. III: "Institutional Facilities, Services and Finances, 1978-79," Cat. 83-205.

During the fiscal year 1977/78, extended health care was provided in Canada by 3,909 special-care facilities with 194,000 beds. Operated by private enterprise, by various lay organizations and religious institutions, and by local and provincial governments, these facilities extend care to the aged, to the physically and mentally handicapped, to emotionally disturbed children, to unwed mothers, to alcoholics and drug addicts, and to delinquents, transients, and others. In total, they provided 46 million days of resident care, or roughly the same as that of all general and allied hospitals combined.

The responsibility for payment of extended health care services rests primarily with government. Under Established Programs Financing, certain funds are provided for extended care. With the help of these funds, provincial health insurance covered about one-third of the costs of extended care; provincial social assistance, partially funded under the Canada Assistance Plan, covered another one-third; private citizens, and religious and other organizations, provided one-quarter; and municipalities covered the small remainder. Operating expenditures ran at $25 to $30 per day in 1977/78, or at less than one-fifth the cost of the average hospital day. Depending on the type of care, the cost per day varied from a low of $23 for the aged, to $34 for the mentally handicapped, to a high of $79 for delinquents. Provincially, they varied widely, from a low of 66 per cent of the Canadian average in Alberta to a high of 150 per cent in Quebec. Irrespective of the type of care, costs per day were generally lowest in Nova Scotia and the four western provinces, and they were highest in Quebec (Appendix Table D-7).

On the basis of available statistics, it is not possible to say at present whether there have been any significant breaks in long-term trends in recent years or whether some provinces have integrated their extended care services more closely with general and allied hospitals than others. The reason for this is that statistics on costs and services have only been collected nationally since 1975, and they are not yet as reliable or as comparable among provinces as the statistics of general and allied hospitals, or mental institutions.

Expenditures on Physicians' Services

Since 1960, per capita expenditures on physicians' services have more than quadrupled, increasing from roughly $20 per capita to $120, as indicated by Appendix Table D-8. Part of this rise in expenditures has resulted from greater accessibility to service (more physicians per capita); part, from more intensive care for the same type of disease; part, from better insurance coverage; and part, from an increase in price per unit of service. Data are not available to quantify the contribution of each of these factors over longer periods of time. Selected indicators, however, can be used to convey some first impressions.

Accessibility to medical services is frequently measured by population/resource ratios. In the case of physicians, the average number of people per physician represents such a ratio. It does not, of course, fully reflect the volume of medical services rendered because it does not allow for changes in the nature and quality of these services or for changes in the degree of specialization or the workload of physicians. In addition, such a ratio does not reflect improved diagnostic and therapeutic techniques, better access to hospitals, or the use of more sophisticated equipment. Also, the volume of services is not necessarily the same as access to physicians' services. These qualifications suggest that population/physician ratios ought to be interpreted with caution when considering them as a measure of accessibility.

Over the years, population/physician ratios have steadily declined – for example, from more than 850 persons per physician in the early 1960s to fewer than 650 in 1980. Although this change has occurred in all provinces, there remain substantial variations among them. British Columbia, Ontario, and Quebec have the lowest ratios, having had only about 600 persons per physician in 1980, while New Brunswick, Prince Edward Island, and Newfoundland lag behind, with more than 800 persons per physician (Table 7-11).

While it is not possible at present to measure the long-term changes in the quantity and quality of services rendered by the medical profession, interprovincial comparisons of recent years provide some further insight. To quantify the provincial variations in physicians' services more accurately, better measures of inputs and outputs are required. Physicians perform many services, ranging from open-heart surgery to administrative duties and pure research. To allow for the full range of their services, certain adjustments are required.

First, the number of active civilian physicians is converted to "fee-practice" physicians and to "full-time physician equivalents." Fee-practice physicians include only those who primarily practise their profession on a fee-payment basis; those who work primarily in government administration, medical research, and certain other areas are not included. Their conversion to full-time physician equivalents

Table 7-11

Population per Active Civilian Physician,[1] Canada, by Province, Selected Years, 1961-80

	1961	1965	1971	1975	1980
	(Number of persons)				
Newfoundland	1,991	1,744	1,179	939	853
Prince Edward Island	1,149	1,214	1,145	1,000	844
Nova Scotia	1,044	1,003	838	761	673
New Brunswick	1,314	1,328	1,148	987	959
Quebec	853	1,022	828	710	619
Ontario	776	885	742	659	626
Manitoba	823	950	795	713	661
Saskatchewan	973	992	921	809	780
Alberta	982	955	802	785	765
British Columbia	758	810	677	626	558
Canada[2]	857	955	791	703	646

1 Estimates exclude interns and resident physicians and thus are not comparable to the estimates in Table 7-2.
2 Including the Yukon and the Northwest Territories.
SOURCE Estimates by the Economic Council of Canada, based on data from Health and Welfare Canada.

allows for the fact that some of the fee-practice physicians work only part-time. Second, physicians' services are grouped according to specialties and activities. Within each specialty, gross payments per physician vary among the provinces, partly because of provincial variations in the fees charged per activity and partly because of provincial variations in the volume of services per full-time physician equivalent in each specialty. To "standardize" for such variations in fee schedules, at least as far as data permit, the Canadian average fee is substituted for the provincial fee in each of the different specialties and for each of the numerous activities.

These adjustments are made to ensure that comparable activities of physicians are evaluated at comparable rates all across Canada. In this way, a complete examination by a general practitioner, for example, is evaluated at the same fee level in all provinces, and a complete examination by a specialist of internal medicine is evaluated at a different fee level, but at the same rate per examination in each province. By means of this adjustment, different activities by the same specialist – for example, the excision of an aneurysm or the insertion of an electronic heart device by a specialist in cardiac and thoracic surgery – are evaluated at a different fee level, but at the same rate for the same surgical procedure in all provinces. This was done for each of 18 specialties and each of 116 activities for each of the ten provinces. Although it was not possible to completely standardize for the total number of services performed and for every type of service performed, the estimation procedure was thought to be detailed enough to yield a first approximation of provincial variations in physicians' services.

The output of physicians, as measured by the volume of services per full-time physician equivalent, varies among the provinces by 20 to 30 per cent. Provincial variations in the output of physicians result partly from the degree of specialization and partly from the output per physician in individual specialties. The effect of specialization, however, is quite small and accounts for only about one-tenth of the provincial variations. Quebec is the only province where specialization has a positive effect; in the other provinces it has a slightly negative effect or none at all. Most of the provincial variations in output per physician can be attributed, therefore, to higher or lower output by physicians in individual specialties, as shown in Appendix Table D-9.

These estimates of provincial variations in the output of physicians can be combined with the corresponding numbers of physician equivalents and population size to arrive at a measure of provincial variations in access to physicians' services. It quantifies, on a per capita basis, the total volume of services rendered by physicians in each province relative to the Canadian average. So measured, access to physicians varies considerably among the provinces. It is as much as 40 per cent below the national average in the Atlantic region, as much as 15 per cent below average in the Prairie provinces, and as much as 10 per cent above average in the central region. The conclusion suggested is that, in spite of federal and provincial funding of medical care, some of the traditional disparities among the provinces have not been eliminated (Table 7-12).

Estimates of provincial variations in physicians' services depend to some extent on the kind of measure applied and the period of time considered. Estimates for the year 1977/78, based on a shorter time period and on a somewhat different measure, do not yield exactly the same results. Nevertheless, they confirm essentially the same pattern of provincial variations – a lower volume of physicians' services per capita in the Atlantic region and a somewhat higher volume in the provinces of Quebec, Ontario, and British Columbia. This pattern is also quite similar to that of hospital services. Various indicators of hospital services, such as expenditures per capita, patient-days per capita, and cost per patient-day, convey essentially the same impression.

Table 7-12

Provincial Variations in the Volume of Physicians' Services per Capita, Canada, Fiscal Years 1974/75 to 1977/78

	Relationship to national average (Canada = 100)	
	1974/75 to 1976/77	1977/78
	(Per cent)	
Newfoundland[1]	60	61
Prince Edward Island	80	79
Nova Scotia	91	93
New Brunswick	74	77
Quebec	108	102
Ontario	106	110
Manitoba	92	90
Saskatchewan	98	91
Alberta	88	85
British Columbia	103	97

1 Estimates of Newfoundland's full-time equivalents are not strictly comparable with those of other provinces when used as a measure of physician inputs per 100,000 population because they exclude the physicians employed by cottage hospitals, who are classified as salaried and not as fee-practice physicians.

SOURCE L. Auer and J. Menic, "Provincial Variations in the Productivity of Physicians in Canada, 1974-76," Economic Council of Canada, Discussion Paper 205, September 1981; and Health and Welfare Canada.

Levels of Service

In the preceding review of provincial health services we observed wide variations in costs and services. In 1976/78, hospital operating expenditures varied on a per capita basis from a low of 66 per cent of the Canadian average in Prince Edward Island to a high of 117 per cent in Quebec (Table 7-7). Patient-days per capita and costs per patient-day contributed in nearly equal proportions to these variations (Table 7-8). Provincial variations in patient-days resulted in part from long-standing differences in the age distribution among provincial populations (Table 7-9) and from sizeable differences in hospital admission rates and length of hospital stay (Appendix Table D-2). Provincial variations in costs per patient-day were traced primarily to differences in labour hours per patient-day and wage rates per hour (Table 7-10). A break in the long-run trends occurred in the most recent years. It was shown to result, in part at least, from provincial variations in the degree of integration of psychiatric services, such as the integration of mental institutions, with general and allied hospitals (Appendix Table D-6). Sizeable variations were also observed in the provincial costs of extended health care services (Appendix Table D-7). And, finally, it was observed that the cost and volume of physicians' services varied, on a per capita basis, among the provinces (Appendix Table D-8, and Tables 7-11 and 7-12) and that these variations were as large as those of other health care services.

In view of these findings, it is only natural to ask why, after so many years of "free access" to health care services, these provincial disparities should still exist. If publicly funded health insurance was designed to provide "equal access" for all Canadians irrespective of income level or province of residence, why did the provincial disparities not disappear long ago? In approaching this question, it is necessary, first, to recall that the stated objectives of the federal-provincial health insurance programs were not explicit on this point and that eventually the persistence of a "certain degree of heterogeneity among the provinces" came to be recognized. Established Programs Financing provided the provinces with greater flexibility in financing their services. Second, it needs to be acknowledged that considerable progress in equalization has actually been made. Since the early 1960s, the level of health services has been raised in all provinces, and the disparities have gradually diminished – at least in some areas of service. In the case of physicians' services, for example, the provincial variations in population/physician ratios and in per capita expenditures narrowed substantially (Table 7-11 and Appendix Table D-8). It is more appropriate, therefore, to ask: not why provincial disparities in health services still exist but why they have diminished so slowly.

It has been fairly well established in the literature that there is a close link between the volume of physicians' services, the rated bed capacity, and expenditures on hospital services. The greater the number of physicians per capita, the greater the volume of physicians' services; and the greater the rated bed capacity, the greater the "expected" per capita hospital expenditures. Although there is not a strict one-to-one correspondence among the three, the relation is sufficiently strong to suggest that lower levels of hospital services in the lower-income regions tend to persist because both the volume of physicians' services and the rated hospital-bed capacity are lower.

Earlier it was shown that the volume of physicians' services in some of the Atlantic provinces is substantially lower than in some of the high-income provinces (Table 7-12). This resulted not because productivity of physicians was lower in the low-income provinces (it was actually found to be higher in some of the Atlantic provinces), but because the number of physicians per capita was lower. It is likely that these provincial disparities will persist because the incentives for change are not very strong. If physicians

were paid according to their volume of output – at the same rate per unit of service everywhere – we would expect a match between provincial variations in incomes of physicians and in output per physician. In reality, this is not so. This is partly because the provincial *net* incomes of physicians vary with the provincial costs of maintaining a physician's practice and partly because the emphasis in provincial fee negotiations tends to be on income level rather than on fee schedules, associated expenditures, and volume of services.

There is evidence that physicians in some of the low-income provinces are paid less for their services than their counterparts in some of the high-income provinces. Again, it is not a very consistent relationship. In the Atlantic region, for example, physicians in Newfoundland are paid "less than average" for their services, while those in Nova Scotia are paid "more than average." In the central region, Quebec's gross payments and earnings seem to be out of line, but net earnings and net income are close to output per physician. All of Ontario's income estimates are very close to the volume-of-service estimates. By the same criterion, Saskatchewan's physicians are paid less for their services, while Alberta's physicians are paid more. The payments to physicians in British Columbia are well above their productivity, but their net income is nearly the same as their productivity (Appendix Table D-10).

We conclude, therefore, that physicians of Newfoundland, New Brunswick, and Saskatchewan are paid below their levels of output, while physicians of Nova Scotia and Alberta are paid above their level of output. This is a tentative conclusion. Output of physicians – measured here by volume of service – is merely a quantitative measure and not designed to capture variations in the quality of services. At present there is no conclusive evidence, however, that provincial variations in quality of service would compensate for the provincial differences between volume of service and income of physicians.

It would be simplistic to assume that a closer alignment of the income of physicians with the volume of their services – for example, by instituting more uniform fee schedules – would automatically lead to a more rapid adjustment of provincial variations in the level of physician and health services. Other factors are also involved.

Recently the Canadian Medical Association called for a $15-billion increase in spending on health care by 1985 and warned that services are about to decay because of "inordinate" penny-pinching. In a brief to the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements, the physicians claimed that extra billing of patients, strikes, potentially dangerous overcrowding, and long hospital waiting lists are all symptoms of widespread underfunding. They pointed out that health care expenditures in the United States exceeded 9 per cent of GNP, while Canada lagged a full 2 percentage points behind.

Although such expenditure comparisons are not proof that Canadian health care funding is inadequate, they are used as background material for income negotiations. Other comparative measures are used more directly. The growth rates of physicians' incomes, for example, are compared with consumer price inflation or with the rate of wage inflation, and physicians' incomes in one province are compared with those in the others or with the incomes of other professionals.[24] Comparisons of this kind are usually based on recent experience and not on long-term trends. While it is evident that physicians' incomes declined relative to the incomes of other professionals during the early 1970s, they rose again recently, and today they compare favourably with the early 1960s, the time of inception of the federal-provincial health insurance programs, as is evident from Chart 7-3.

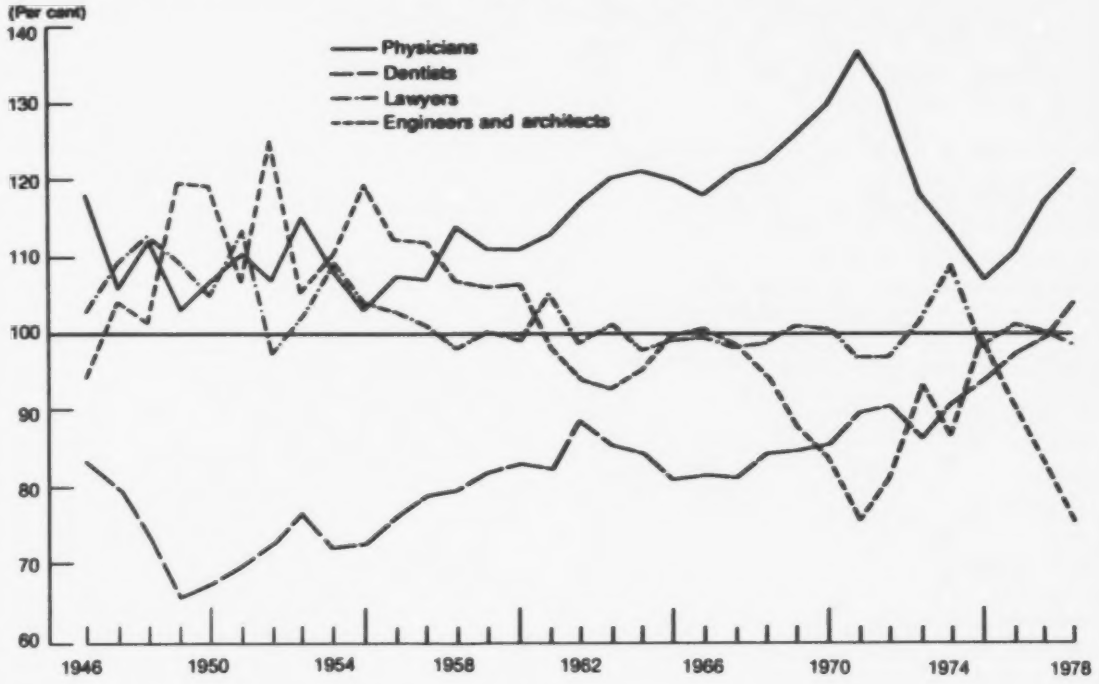
Provincially, the national pattern repeats itself. Physicians' incomes are higher today than those of other professionals in most provinces. They are not as high as they were in the early 1970s, but they compare favourably with the early 1960s. It is noteworthy that in 1978 the earnings of physicians in the Atlantic provinces exceeded those of other professionals by a better-than-average margin. By contrast, the earnings of physicians in the provinces of Saskatchewan and Alberta fell short of the average margin (Appendix Table D-11).

Comparing these relative income positions of physicians with earlier provincial variations in service volume and in incomes of physicians (Appendix Tables D-9, D-10, and D-11) suggests that physicians in Saskatchewan are paid less on both accounts: less in relation to other professionals and less in relation to their volume of service. Physicians in Nova Scotia, on the other hand, are paid more on both accounts. In other provinces, the relation between the two sets is not so one-sided. The income position of physicians in Newfoundland, for example, is close to the national average relative to that of other professions, but physicians there are paid less relative to their volume of service.

If provincial disparities in the levels of physician and hospital services were to be reduced by increasing

Chart 7-3

Relative Taxable Incomes of Selected Professionals,[1] Canada, 1946-78



1 Income of one professional as a percentage of the average income of four professionals.
SOURCE Based on data from Revenue Canada and Health and Welfare Canada.

the number of fee-practice physicians in some of the low-income provinces, a closer alignment between physicians' fee-payment schedules and service volume could provide the needed market incentive. Extra fee payments could be justified in provinces where physicians are currently paid below the national rates, especially if their relative income positions were below average as well. Such incentive payments could be made more effective if medical training facilities were developed or if existing ones were expanded at the same time. Improved market incentives and easier access to educational facilities should lead to a greater number of physicians. This, combined with an expansion of hospital facilities, should bring about an increase in physicians' services, improve access to health care services in general, and make for a more rapid adjustment of provincial disparities.

Raising the level of physician and hospital services in the low-income regions would not be without costs. It would impose an extra burden on the rest of the country if it were done without compensatory adjustments in other provinces. Neither adjustment would be of great merit, however, if the sole objective of federal-provincial funding of health insurance were to provide for a minimum level of access to health services in all provinces. A minimum level of access has already been achieved in most, if not all, provinces over the past two decades. Adjustment policies could become important, however, if they were to be directed at the attainment of more uniform levels of service across the country.

Conclusions

As our analysis has shown, federal-provincial health insurance programs have made health services more accessible to Canadians in all provinces. While

certain broad objectives such as comprehensiveness of service and universality of coverage have clearly been met, early hopes for the attainment of national standards of health care services have not been realized. Substantial variations in hospital and medical care services persist among the provinces. Although it is quite conceivable that health services could be made more uniform across Canada, it is not clear at present what levels of service would be optimal. For example, how much merit would there be in raising the standard of services of some of the lower-income provinces to that of the highest-income provinces? Would Canadians benefit more from more-intensive medical care than from easier access to extended health care services? This lack of precision stems partly from the inadequacy of our present-day knowledge and partly from the sheer lack of statistical information, especially in the area of extended health care services.

Notwithstanding these problems with regard to information, our statistical analysis shows that part of the provincial variations in hospital costs arise from provincial variations in age distribution. The age distribution of the population is an important cost factor because, provincially, it affects hospital admission rates and length of hospital stay. It lowers the hospital operating costs in Newfoundland, Quebec, and Alberta (the provinces with younger populations), and it raises them in Prince Edward Island, Manitoba, Saskatchewan, and British Columbia (the provinces with older populations). These provincial variations in age distribution account for a significant part of the provincial variations in hospital operating costs, but under the present EPF arrangements no allowance is made for them. Appropriate adjustments in funding could be made without raising the national cost of the health insurance program.

8 The Fiscal Arrangements Act and the Conduct of Economic Stabilization Policy in the 1980s

As federal and provincial authorities have always emphasized, one central ingredient of intergovernmental relations in our federal system should be federal-provincial co-operation in all relevant areas of economic policy. This is particularly important in the highly interrelated sphere of economic stabilization policy.

Three main issues involving stabilization policy need to be considered in the context of federal-provincial fiscal arrangements. The first is the rationale for provincial participation in stabilization policy and for federal-provincial co-operation with respect to such policy. The second is the scope and limits of federal-provincial co-operation on the basis of the distinction between sharing of information and sharing of policy objectives. The third is the practical connection between the federal-provincial fiscal arrangements and stabilization policy, with particular emphasis on the implications for economic stability of the growing size of the provincial sector in relation to the federal sector and of the cyclical sensitivity of provincial budgets. The analysis of this third issue is particularly concerned with examining the question as to whether the growth in the size of the provincial sector has reduced the effectiveness of stabilization policy measures. Also examined is the question of whether any new fiscal arrangements in future should be aimed at modifying the impact of changes in the cycle of economic activity on provincial budgets in an effort to achieve greater economic stability.

The Case for Stabilization Policy

Before considering these three issues, it is necessary to examine the more fundamental question of whether stabilization policy actually retains any relevance today and, if so, how it can be made more effective in the 1980s. A decade, or even half a decade, ago this question would never have arisen. It would have been assumed that a wide array of fiscal and monetary measures could and should be employed effectively in order to achieve reasonably sustained growth of output and employment under conditions of reasonable price stability. This conventional wisdom has come to be seriously questioned in more recent years by a number of economists, however, in the wake of a prolonged period of slow growth, high unemployment, and soaring inflation – all of which are cited as proof of the failure of stabilization policy.

As already indicated, stabilization policy involves the adoption of a variety of fiscal and monetary measures aimed at maintaining the highest possible growth of output and employment that is consistent with the maintenance of price stability. What the target for growth of output and employment should be depends on a number of factors: the structure of the labour, capital, and product markets; the intensity of inflationary pressures; and views on the social costs of inflation and unemployment, and on the presence or absence of other complementary policies aimed, for example, at reducing costs, increasing productivity, or controlling prices and earnings. A number of issues relating to achievement of the goals of stabilization policy have been discussed extensively in recent Annual Reviews published by the Economic Council. Basically, the objective of stabilization policy in recent years has been to offset short-term national or international forces that tend to push unemployment levels too far above or below those considered acceptable in the prevailing economic circumstances at home and abroad.

While stabilization policy in Canada is conducted in a federal context, it can be affected by measures adopted by both the federal and provincial governments. How the two levels of government exercise this shared power would not be a matter of concern if fiscal or monetary measures did not have any important effects on national income and employment. In fact, we know that fiscal and monetary policies can have a major impact on the short-term performance of income and employment. The multiplier effects of changes in taxes and expenditures or of interest and exchange rates on the level of economic activity and

prices can be substantial over a period of six months to two years.

Although the performance of the economy in the past several years has been far from satisfactory, it should be recognized that it might well have been much worse in the absence of measures aimed at sustaining output and employment and containing inflation. In no small measure, a degree of stability has been achieved through the automatic tax and expenditure mechanisms built into the system, a notable example being the countercyclical function of unemployment insurance to bolster incomes and market demand during periods of faltering economic growth.

We remain convinced, however, that there still remains significant room for improvement in the exercise of discretionary measures aimed at promoting economic stabilization. In the first place it is necessary to avoid a return to the excessive fiscal and monetary activism of the 1960s and early 1970s. This is not to suggest that stabilization policy should be inactive, but rather that it should follow a more cautious brand of activism – one that takes more realistic account of the lags, uncertainty, rigidities, and allocative and distributive constraints that exist in the economy. Still another way of improving discretionary stabilization policy would be through a better understanding of the scope for limits on federal-provincial co-operation in the implementation of stabilization policy decisions. The latter mainly involves *fiscal* stabilization measures since monetary policy is entirely under federal control.

The Rationale for Federal-Provincial Co-operation in Stabilization Policy

The concept of provincial participation in economic stabilization is now well established in the theory and practice of policy making in Canada. The Council strongly advocated such provincial participation in its 1977 report entitled *Living Together*,[1] and it continues to hold to that view.

The provinces today occupy a dominant position in the public sector, which in turn plays a major role in the economy as a whole. Although receipts of provincial governments from their own-revenue sources amounted to 15.1 per cent of the GNP in 1980, compared with 17.0 per cent for the federal government, provincial revenues after intergovernmental transfer payments represented 19.8 per cent of GNP, while federal revenues amounted to only 12.7 per cent. The provinces are also responsible for about 75 per cent of public investment in the federal-provincial sector, and they have a decisive influence on a large percentage of investment by municipalities, educational institutions, health and social service institutions, and provincial Crown corporations. Hence provincial budgets inevitably have a major impact in the short run on both national and regional economic performance regardless of whether or not this impact is a deliberate design of their policies. It is, however, far more preferable for provinces to take full account of the requirements for stabilization in formulating their budget measures than for them to adopt an attitude of benign neglect.

As a matter of principle, we believe that co-operation between the provinces and the federal government in the area of fiscal stabilization policy is just as fundamental for economic performance as co-operation between the Bank of Canada and the federal Department of Finance with respect to aggregate demand management in general. There are two important points that need to be mentioned in this connection.

First, it follows, given the magnitude of the provincial position in the public sector, that the need for provincial government measures to reinforce national stabilization policy is proportional to the degree to which economic stability is threatened whether by developments at home or abroad. If the federal instruments of monetary and fiscal policy are required to bear the burden of stabilization policy alone, there is a risk that the economy could face one of two possible adverse consequences. On the one hand, if stability is to be achieved, federal changes in expenditures and/or in interest, exchange, and tax rates would have to be pushed much further than if federal and provincial policies were mutually supportive. In this case there is a danger that these more extreme measures could have serious side effects in terms of economic growth, efficiency, and equity of income distribution. On the other hand, there is an equal danger that federal stabilization measures would not be pushed far enough to achieve their primary purpose for the simple reason that the federal government might be concerned about the adverse economic and political consequences of the side effects.

Second, it is equally evident that provincial stabilization measures have a particularly important role to play in cases where specific regions bear the brunt of economic upheavals, especially where the ability of the federal government to counter particular regional impacts is limited by the policy instruments at its disposal. The relevance of this consideration stems from the fact that the regional swings in the business cycle are very diverse; that occurrences of demand disturbances of specific provincial origin are frequent and well-documented; and that explicit regional

differentiation of the federal budget would be economically costly and politically difficult to conceive and implement on the scale required to meet regional shocks.

The Scope and Limits of Federal-Provincial Co-operation in Stabilization Policy

As indicated previously, the concept of provincial participation in the national and regional stabilization effort is now well established in the theory and practice of stabilization policy in Canada. Given the highly interactive nature of the economic relationships in the Canadian federation, however, it is also crucial that the two levels of government work in co-operation, not in isolation. This was emphasized by the *Report of the Royal Commission on Taxation* [the Carter Commission] in 1966[2] and reiterated by the Council's 1977 Report, *Living Together*.

The nature of the co-operation required with respect to stabilization policy is not always clearly understood. Such co-operation may, in fact, involve one or both of the two essential ingredients involved in the policy-making process – namely, the exchange of economic information on which decisions must be based, and the undertaking of mutually supportive action to achieve agreed-upon objectives.

It is undoubtedly the case that a minimal condition for achieving a co-operative stabilization policy involves the exchange of extensive information between federal and provincial governments on the past, present, and prospective operation of the economy and also an exchange of views on what should be the objectives of stabilization policy and how those objectives might best be met through fiscal and/or monetary measures. On that count, considerable progress has been made over the past several years. The annual federal-provincial conferences on the economic outlook, budget priorities, and borrowing policies are only the culmination of a continuing exchange of views and information carried on throughout the year between the Bank of Canada and the federal and provincial finance departments. This is a process that yields considerable benefit both nationally and provincially and certainly one that should be supported and encouraged.

The sharing of information and views, however, does not ensure full achievement of the second ingredient of co-operation – agreement on the most desirable objectives of stabilization policy and the best means of realizing those objectives. While the exchange of information and views may be helpful in achieving some degree of harmony on objectives and the means of attaining them, there are bound to be differences of opinion from time to time between the 11 governments involved (if only in terms of emphasis) on the thrust of fiscal policy. Unless one were prepared to negate the spirit of Canadian federalism by authorizing the national government to coerce or entice provincial governments into following the stabilization measures dictated by the federal government, which has on occasion been suggested, some differences in the thrust of policy followed by the federal government and at least some of the provinces are inevitable. While it is obviously desirable to achieve the greatest possible extent of harmonization in the stabilization policies pursued by the two levels of government, some divergence that takes account of regional diversity also has much to be said for it and, in any case, can only be expected in a federal system. Certainly we would strongly oppose the adoption of any measures aimed at inducing the provinces into following a stabilization policy determined by the federal government alone.

Federal-Provincial Fiscal Arrangements and Stabilization Policy

Traditionally, the discussions leading to the renewal of the federal-provincial fiscal arrangements have also involved the related question of stabilization policy, because of two underlying factors. First, there has been concern, at least since the Report of the Carter Commission, that the rapid growth of the provincial government sector and its increasing reliance on direct taxes, which are very sensitive to changes in incomes, could be destabilizing if the provinces attempted to balance their budgets regardless of stabilization needs. This concern has stemmed from a fear that in times of economic recession the provinces might take steps to offset the resulting decline in their revenues by decreasing expenditures, increasing taxes, or both, which in turn would only aggravate the economic slowdown by reducing disposable income and demand for goods and services. Conversely, there has been a fear that in boom times provincial fiscal policy might serve to fuel already excessive growth. It follows, of course, that in the event the provinces did pursue such perverse policies, the countervailing force of federal stabilization policy would have to be that much greater, increasing the risk of the adverse side effects referred to earlier.

Even if it is acknowledged that, on balance, provincial fiscal policy has not worked against stability, there has been a second concern with respect to the interrelationship between the federal-provincial fiscal arrangements and stabilization policy. This concern is that the tax and transfer systems might influence the *extent* to which provincial

governments would co-operate in the stabilization exercise, in particular with respect to their willingness to incur deficits in a prolonged recession because of the associated high borrowing costs. Again, at least since the Report of the Carter Commission, proposals aimed at alleviating the borrowing costs faced by the provinces in a protracted recession have abounded. One proposal, made by the Carter Commission itself, in effect involved increasing federal-provincial transfers in recessions and decreasing them in periods of excessive growth so as to counter the impact of cyclical swings on provincial revenues and, in particular, the need for provincial deficit financing in recessions. Another type of proposal envisages a federal-provincial agreement under which the provinces would be permitted to issue bonds at the lower *federal* interest rate up to a maximum amount, according to the state of the economy.

Studies undertaken on the Council's behalf of the actual impact of stabilization policy as it has evolved since 1939 point to a number of conclusions with respect to these proposals.[3] First, it is evident that, on balance, the automatic adjustment mechanisms built into the federal fiscal system since 1939 have served to increase economic stability. It is true that the relative importance of federal expenditures on goods and services – as opposed to transfer payments to other governments, firms, families, and persons – has been decreasing as a proportion of GNP ever since 1955. In addition, there has been a major shift in revenues from the federal to provincial governments as a result of the transfer of tax points. These developments, however, have been more than offset by two major factors. One is the increasing marginal rate of federal taxation, which has resulted from the interaction of increases in monetary incomes and the progressiveness of the income tax system (notwithstanding indexation). As a consequence, in times of recession and falling incomes, federal taxation declines significantly, thereby helping to bolster demand in the economy. The second major factor relates to the 1971 revisions of the Unemployment Insurance Act, which have had the effect of substantially increasing the amount of transfer payments to the unemployed in times of economic recession; this has also served to bolster the economy. In addition, the magnitude of *total* federal expenditures as a proportion of GNP has increased considerably as a result of rising transfer payments, not only to other levels of government but also to persons through such programs as old age pensions; family allowances; and, of course, unemployment insurance. These transfer payments themselves have added a measure of stability to the economy, reducing the extent of further discretionary fiscal measures required to balance swings in the private sector.

The second conclusion to emerge from our analysis is that, contrary to earlier concerns, the relative increase in the size of provincial budgets and their greater reliance on direct taxes have almost certainly contributed to the achievement of economic stability and reduced the magnitude of discretionary measures that must be adopted by the federal government in support of this goal. In part this is due to the fact that the provincial sector has grown largely at the expense of the private sector rather than the federal sector, which in turn has reduced the impact of cyclical private sector swings. In part it is due to the fact that provincial fiscal policy over the past 15 years has not been "perverse," as some feared it might be, but has generally been supportive of federal stabilization measures.

One of the central implications that flows from these conclusions is that any further shifts in fiscal responsibilities from the federal government to the provinces are likely to have only minimal consequences in terms of stabilization policy. This is particularly so, because any such shifts would probably involve types of expenditure that are not usually varied for stabilization purposes – for example, spending on postsecondary education and health services. Whether greater fiscal decentralization is desirable on other grounds remains open to consideration. Our central point is that it should not be rejected on the false premise that such a course would have adverse consequences for the effective implementation of stabilization policy.

When we turn to another aspect of the issue, that of the link between the automatic response of provincial revenues to changes in the economic cycle and the part played by the provinces generally with respect to stabilization policy, there is one point that clearly emerges. Thanks mainly to the operation of the federal unemployment insurance system, provincial budgets are two to three times as stable in the face of cyclical swings as the federal budget. According to calculations based on the Council's CANDIDE econometric model, every decline of $1 in GNP brought about by a reduction in aggregate demand tends to cost the federal government between 25 and 30 cents as a combined result of the reduced revenues and increased transfer expenditures that occur automatically under the federal fiscal system. Of that amount, some 11 to 14 cents is the result of increased unemployment insurance payments. By contrast, in the same circumstances the cost to all provincial governments combined is only about 10 cents for every $1 decline in GNP. An opposite type of swing occurs in the expansionary phase of the economic cycle. This smaller variance in the provincial fiscal position over a full business cycle is to be

welcomed. While the provinces play a constructive role in support of stabilization policy, the smaller shifts in their fiscal position lessen the need for them to engage in costly borrowing in recession, and it reduces the incentive for excessive expenditure growth in times of strong economic growth.

Although it would be possible, as the Carter Commission proposed, to introduce a greater anti-cyclical element in federal-provincial transfers, the provinces would have to be compensated in some way by the federal government for adopting more active stabilization measures. The Carter Commission proposal would have the effect of making provincial budgets inherently even more stable and the federal budget more unstable than at present. We remain unconvinced, however, that such a scheme would be worth its cost. The low sensitivity of provincial budgets to changes in the economic cycle and the lack of evidence that borrowing costs are an important deterrent to provincial acceptance of cyclically induced deficits diminish the urgency of increasing the anti-cyclical characteristics of federal-provincial transfers. Moreover, even if such a scheme would make the provinces more active in stabilization policy, the accompanying increase in the cyclical instability of the federal budget could cause the federal government to shy away from adopting the stabilization measures required by the circumstances because of uncertainty about whether the benefits in terms of stability would be worth the economic and political cost. Finally, we are concerned that the scheme would generate unending intergovernmental conflict. It would require joint government efforts to determine, every year, the degree of cyclical change, the amount of funds to be transferred to the provinces, the amount to be subsequently returned to the federal Treasury, as well as the conditions that might be imposed on provincial actions in exchange for the transfer of funds.

Our reaction to the proposals that allow the provinces to issue bonds in recessions up to predetermined amounts at federal interest rates is similar to that made to the above proposals of the Carter Commission. The willingness of provincial governments to incur deficits in recessions would be only marginally affected by these proposals, and they would carry the same danger of generating intergovernmental conflicts.

Conclusions

The foregoing examination of the implications for stabilization policy of the federal-provincial fiscal arrangements suggest two conclusions. First, in spite of the concerns that have been expressed, we consider the efficiency of stabilization policy and the relative size of the federal and provincial government sectors to be largely independent and unrelated issues. Second, we are satisfied with the present comparative levels of sensitivity of the federal and provincial budgets to the business cycle and, as a result, with the part played by each level of government with respect to stabilization policy. The stabilization benefits to be obtained from alternative fiscal or financial arrangements would appear to be too small to warrant the additional institutional costs they could generate.

9 Tax Collection Agreements and the Objectives of Tax and Fiscal Harmonization

The Issues

In outlining the principles of equalization, the analysis in Chapter 3 emphasized the importance of the concept of provincial "net fiscal benefits," defined as the difference between the benefits a resident receives from provincial fiscal activities and the costs he or she incurs for those benefits. The discussion established that equalization of net fiscal benefits among provinces is necessary for the efficient allocation of the nation's resources. The realization of such a condition could be defined as the attainment of "fiscal harmonization," something that is not easily achieved in a federal state.

The present chapter focuses on one of the main factors determining the level of net fiscal benefits in each province – namely, taxes. The importance of this focus may be questioned because, regardless of the specifics of the provinces' tax structures, it is possible to design an equalization scheme that has the potential to offset significantly any adverse consequences with respect to the allocation of financial resources. This contention is partially correct, and it leads to an important conclusion – namely, that the Equalization Program represents an important harmonization tool.

Given the independent decision-making power of the provincial governments with respect to taxation, however, it may not be desirable, or possible, to rely exclusively on a system of intergovernmental transfers to achieve fiscal harmonization. The reasoning behind this view can be briefly outlined. In the first place, the amount of equalization needed is determined by the particular policies set by the provincial governments. To take an obvious example, if no province taxed corporate income (that is, if each province set its tax rate on corporate income equal to zero), there would be no reason to equalize on this score. Because of this fact, it can be argued that the pursuit of fiscal harmonization is appropriately approached by employing a package of policies, incorporating tax co-ordination measures and an equalization program – as well as the various conditional and unconditional grants – as components for achieving equity and efficiency objectives.

A second reason for not relying exclusively on a system of intergovernmental transfers to achieve fiscal harmonization is that a particular province can, and may, pursue objectives not completely consonant with the "global" objective of fiscal harmonization. This has some important implications. As discussed in earlier chapters, there may exist some consequences for efficiency when provinces adopt differing goals with respect to the redistribution of income. Another issue arises from the roles assumed by provincial governments in promoting the development of their economies. Although provincial governments properly have an important role to play in this area, there is cause for concern when the policies of one province attract investment capital and people at the expense of other provincial jurisdictions. Understandably, the latter provinces may well feel compelled to adopt offsetting measures in an effort to protect their own interests. One important factor determining their ability to do so is their relative financial capacity. The policy question to be considered here is the degree of autonomy that can reasonably be surrendered by all provincial governments in pursuit of the economic gains that can be derived from the Canadian economic union.

A third reason why it may not be desirable, or possible, to rely on intergovernmental transfers alone to achieve fiscal harmonization involves several important considerations with respect to the tax treatment of persons and firms in a federal state. Two sorts of problems arise.

First, many businesses and persons carry out economic activities that generate income in several provincial jurisdictions. Broadly speaking, provinces are able to tax all economic activities within their boundaries. In these circumstances, some types of income may be subject to multiple taxation or may

escape taxes altogether – a result that has adverse consequences both for efficiency and equity.

These kinds of problems in federal countries parallel similar problems with international taxation. In many cases, countries have entered into bilateral treaties to avoid the excessive distortions caused by double taxation. In addition, these international treaties often prohibit the imposition of taxes by signatory countries that explicitly discriminate against non-residents.

The second problem stems from the joint occupancy of tax fields by both the provincial and federal governments. Close co-ordination between the two levels of government with respect to the nature and form of these taxes can offer significant economies both in the administration costs of all governments and in the compliance costs of taxpayers. Again, one way to approach these problems is in terms of the possible trade-off between the loss of provincial autonomy and the benefits of co-operation.

In Canada today, the provinces, in the pursuit of their economic and social goals, employ a wide variety of taxes and other levies as instruments for raising revenue. The federal-provincial Tax Collection Agreements, which make up Part III of the Fiscal Arrangements Act, encompass the important revenue sources of personal and corporate income taxes; both fields are occupied by the two levels of government.

While much of the following discussion focuses on these two tax areas alone it should be acknowledged that this approach has certain shortcomings. Consideration of the tax side alone obviously ignores the benefits provided from such revenues; consideration of income taxes alone overlooks the total tax burden on persons and firms in a province, which is determined by all levies to which they are subject. This has implications for the criteria by which we can reasonably judge the Tax Collection Agreements themselves.

In summary, the goals of these Tax Collection Agreements are:

- fiscal harmonization;
- minimization of administration and compliance costs;
- the avoidance of double taxation; and
- the avoidance of discriminatory taxation measures.

All four of the objectives listed above have to be considered within the context of the autonomy of provincial governments to pursue their own social and economic goals.

While the main focus of this chapter is on taxation issues, it is impossible to ignore another important set of provincial public policy instruments: namely, regulation, procurement policies, and marketing boards. Although they serve a variety of purposes, these instruments can also be used to influence the mobility of goods, labour, and capital in the Canadian economy. A discussion of how provinces pursue their objectives must consider *all* the tools at their disposal and how these tools can substitute for, or complement, one another. While these policy instruments obviously stand apart from issues of taxation, their relevance to the goals of a federal state makes them an important component of a prospective "Code of Conduct," which is discussed later on.

In considering the question of fiscal harmonization, it is also necessary to take account of the many federal and provincial Crown corporations that are currently engaged in commercial activities because of the special tax status they enjoy.

The next section of this chapter outlines the present Tax Collection Agreements and their evolution. The subsequent two sections weigh the advantages and disadvantages of the present system, particularly in the context of certain recent disputes between the federal and provincial governments. The primary aim is to determine what is worth preserving in the Tax Collection Agreements and what areas may need to be strengthened further. Following these sections is a discussion of the tax treatment of federal and provincial Crown corporations.

The Tax Collection Agreements

Federal and provincial governments in Canada employ a variety of fiscal instruments, ranging from taxes on the incomes of persons and firms to broad-based sales taxes at the retail level and manufacturing sales level and specific excise levies on commodities like tobacco, alcohol, and gasoline. The relative importance of different instruments has varied over time. In Canada today, as in most other federal countries, income taxes have come to assume a predominant position both as sources of government tax revenue and as instruments of economic and social policy.

When several jurisdictions have the power to levy taxes, two types of potential problems arise. First, two different levels of government may exploit the same general tax base, as is the case in Canada with respect to corporate and personal income taxes. Co-ordination between governments with respect to the definition of the tax base, the achievement of economies in the collection of taxes, and administration of the system can enhance regional economic efficiency

and taxpayer equity, but the very opposite may be the case if the degree of co-ordination is inadequate.

The second problem is that firms or persons undertaking economic activities in different jurisdictions may be liable to taxation by two or more provincial governments at the same level. For instance, firms can sell, provide services, have production facilities, and employ workers in more than one province. As for workers, their place of employment and their dwelling place may be in different provinces or they may change their province of employment or residence sometime during the year. It is not immediately clear which province or provinces should be entitled to tax the incomes of such workers or firms. Generally, allocation rules have been developed to determine whether, and to what extent, different jurisdictions have a claim against taxable income.

The Tax Collection Agreements, among other things, provide a means of resolving these two potential problems with respect to taxes on personal incomes and on corporate profits. The federal government offers to collect either, or both, of these taxes for any province or territory, provided the jurisdiction establishes income tax legislation that meets certain conditions regarding the definition of the tax base, the allocation rules, and the rate structure.

Personal Income Tax Provisions

The federal government collects and remits provincial personal income tax to any province that adopts the federal personal income tax base and sets a single rate of tax, expressed as a constant percentage of the basic federal tax payable. The federal government assumes all the cost of administration and collection and forwards the assessed amount of tax to the participating provinces. Currently, both of the territories and all provinces except Quebec have entered into an agreement with respect to the collection of personal income tax by the federal government. Moreover, all jurisdictions, including Quebec, have agreed that the taxpayer's place of residence on December 31 of the taxation year determines the province to which he or she is liable for income tax.[1]

Since 1972, the federal government has also undertaken to administer, subject to the conditions discussed below, certain provincial tax measures, for which it charges a fee based on a sliding scale. Under these arrangements, the federal government will make provisions for tax rebates and reductions and for tax surcharges, as stipulated by the provinces that are party to the Agreements. The intent of the conditions, which are not spelled out in any official or legal document, is to prevent the adoption of provisions that, in the opinion of the federal government, would discriminate against residents of the other provinces or that could have the potential to impede the proper functioning of the Canadian economic union. Currently, the majority of provinces take advantage of these provisions allowing personal income tax credits for, among other things, political contributions, property and sales taxes, cost of living, and mortgage interest. Tax rebates for royalties paid are offered by the four western provinces; these provinces and Ontario also offer selective tax reductions. New Brunswick has a negative surtax of 5.5 per cent of provincial tax otherwise payable, and Saskatchewan and British Columbia have imposed surcharges on provincial tax otherwise payable in excess of a specified floor amount. Because it administers and collects its own personal income taxes, Quebec has complete autonomy in the determination of the base, the rate structure, and credits and rebates for these taxes.

Corporate Income Tax Provisions

The centralized administration of corporate income tax is carried out in similar fashion, but the rules for determining the division of taxable corporate income among the provinces are more complex. Participating provinces use the federal definition of taxable profits and are allowed to set a dual rate structure, the lower rate of which applies to firms eligible for the federal small business deduction. Again, the federal government bears the costs of collection, and it forwards to the provinces the assessed amount of tax payable.

How and why a firm is subject to provincial corporate taxation is governed by two factors. First, the liability of a company for taxation in a province is determined by the so-called "permanent establishment" criterion. A company is deemed to have a permanent establishment in a province if it has a fixed place of business there or, alternatively, employs capital or labour above a given level in a province. Second, if a firm qualifies by having a permanent establishment in a province, the tax base against which the provincial corporation tax rate is applied is defined as the taxable income of that firm multiplied by a factor that gives equal weight to the proportion of the firm's payroll and its gross receipts in the province. Because of the nature of their activities, special rules exist for companies that operate in financial, insurance, and transportation industries.

The federal government collects the corporate tax of seven of the ten provinces under these rules. Alberta withdrew from the agreement in 1981 but currently maintains the same rules. A new provincial corporate tax structure may be legislated in Alberta

following consultation with interested persons and firms. Ontario and Quebec, the other two provinces that run their own corporate tax systems, have traditionally maintained base definitions and allocation rules that broadly conform to those used by the other provinces.

In the case of the corporate tax, as in the case of the personal income tax, the federal government administers certain provincial tax credits and rebates for a nominal fee. Currently, Manitoba and British Columbia offer credits for political contributions. British Columbia also offers a credit for logging tax. Saskatchewan and British Columbia offer a tax rebate for royalties paid. In addition, all provinces party to the agreement, except Prince Edward Island, offer a small business rate reduction.

The Development of Tax Harmonization

The system of income taxation outlined above represents a higher degree of co-ordination than exists in many other federal states. It is useful to examine briefly the historical evolution of these arrangements in order to gain an understanding of the nature of the Tax Collection Agreements and the factors that helped to shape their development.

Section 92(2) of the British North America Act confers upon the provinces the power to levy "direct" taxes within their respective jurisdictions. As interpreted by the courts, this power includes, among other things, the right to impose personal and corporate income taxes and succession duties. Section 91(3) permits the federal government access to any field of taxation. The two sections together, therefore, establish the basis for joint occupancy of the income tax field by federal and provincial governments.

By the 1930s, both the federal government and the various provinces had in place taxes on personal income and corporate profits. The provisions governing these levies were uncoordinated in the sense that jurisdictions had different base definitions, rate structures, and allocation rules. This was one of the factors – in addition to the serious financial problems facing all levels of government as a result of the Depression – that led the federal government (in 1937) to appoint a Royal Commission to review the entire fiscal system.[2]

The Commission was highly critical of the complete lack of uniformity in personal tax burdens across provinces and of the host of discriminatory provincial tax measures found to be in effect, such as exemptions for dividend income received from firms with headquarters in a province. In the corporate tax field, the Commission found that different tax rates were being imposed on different industries in the same province, and on the same industry in different provinces. Because of different and conflicting allocation rules, interprovincial companies were often double-taxed on the same income.

The Commission felt that this lack of co-ordination and this discriminatory treatment seriously hampered the attainment of fiscal equity and economic efficiency. Moreover, it concluded in its Report that "duplication of services for the collection of taxes obviously increases costs both of government and of tax compliance" [Book II, p. 177]. Given this concern, it is understandable that the Commission recommended that the provinces withdraw completely from the personal and corporate income tax fields. Under its proposal, these taxes would have been levied only by the federal government, which would have imposed geographically uniform bases and rate structures. In return, provinces would have received from the federal government an annual national adjustment grant designed to enable them to meet a national average level of expenditure without the necessity of levying excessive tax rates in the fields they still continued to occupy. In addition to these grants, it was proposed that each province would receive 10 per cent of the net income derived from mining, smelting, and the refining of ores and oil produced in the province.

The recommendations of the Royal Commission were rejected by the provinces of Alberta, British Columbia, and Ontario at a federal-provincial conference in 1941. The onset of the Second World War, however, had an important influence on federal and provincial attitudes, particularly as they related to the revenue needs of the federal government. The provinces temporarily withdrew from the income tax fields at the urging of the federal government, in exchange for which they received federal transfers – which later came to be known as tax rentals. The system of rentals remained unchanged until new agreements were reached in 1947, and it continued in modified form through the successive agreements of 1952 and 1957. The development of the Tax Rental Agreements and their successor, the Tax Collection Agreements, can be followed more easily with the aid of Table 9-1, which indicates the degree of provincial government control, over time, with respect to the different aspects of the income tax fields.

Beginning in 1947 and extending up to the final set of Tax Rental Agreements in 1957, participating provinces received a per capita payment from the federal government in exchange for withdrawing from

Table 9-1
Degree of Provincial Government Control over Income Taxation under Various Agreements, Canada, 1941-82

	Degree of involvement in:					
		Choice of				
	Tax administration	Tax base	Tax rate structure	Tax rate levels	Base for transfers to provinces	Provinces outside the Agreements
Rowell-Sirois recommendations, 1940	none	none	none	none	– national adjustment grants; – source for certain CIT; – federal assumption of provincial debt and of responsibility for unemployment relief	. . .
Wartime Tax Agreements, 1941-47	none	none	none	none	– revenues obtained from the abandoned taxes in 1940; or – federal assumption of debt service actually paid in 1940	none
Tax Rental Agreements 1947-52 1952-57	none	none	none	none	Two formulas incorporating a per capita payment that recognized either: – fiscal need in the province; or – the revenue capacity of the province in the abandoned fields	Ontario and Quebec (1947-52) Quebec (1952-57)
Tax-Sharing Agreements, 1957-62	none	none	none	none	– source; – explicit equalization introduced	Quebec
Flexible Tax-Sharing Agreements						
a) 1962-67 1967-72	none	none	none	full	– source	Quebec, and Ontario-CIT (1962-72)
b) 1972-77 1977-82	none	none	partial	full	– source	Quebec, and Ontario-CIT (1972-82); Alberta CIT (1981)

CIT – corporate income tax; "source" within the table refers to the source of the tax revenue. The determination of revenue source is discussed in the text.
SOURCE Table has been adapted from a table in G. Break, *Financing Government in a Federal System* (Washington: Brookings, 1981), p. 34.

the personal and corporate income tax fields.[3] The per capita payments incorporated an element of implicit equalization. In 1957, explicit equalization payments were introduced, and a tax-sharing arrangement was negotiated whereby the tax rental was based solely on the source of the taxes collected. A prime motivation for this change of view on the part of the St. Laurent government was that the implicit subsidy for the poorer provinces contained in the tax rentals was unfair to Quebec, which on principle could not accept the loss of provincial autonomy involved in giving up its taxing powers. Another significant change from the previous Agreements was the opportunity for the provinces to split the tax fields and enter into an Agreement for either personal or corporate income taxes – instead of both or none – if they so wished.

The problem of determining where liability rests for the payment of taxes parallels the problem of the choice of allocation rules by a provincial jurisdiction. Two principles of taxation can be followed. The first is the residence principle, whereby taxes are levied on the basis of the province of residence of the wage-earner or the owner of an income-generating asset. The second is the source principle, under which taxes are levied on the basis of the province in which the income is earned.

In the development of uniform rules under the Tax Collection Agreements, first established in 1962, a

number of considerations had to be taken into account in choosing between these two principles. Because it considers the taxpayer's income from all sources in determining tax liability, the residence principle is a more appropriate choice for a progressive tax structure based on ability to pay. For this reason, personal income tax is allocated on the basis of residence. The definition of residence is not perfectly unambiguous, however, especially when the taxpayer changes his or her province of residence sometime during the taxation year. As noted earlier, the test used by all provinces has for some time been the place of residence of the taxpayer on December 31 of the taxation year.

A residence-based corporate profits tax could allocate taxation power to the jurisdiction of incorporation or the place where the headquarters of a company is located. Provincial corporate taxes are usually justified, however, on the basis of the flow of services that a firm receives from the province in carrying on its business. This benefit criterion is more consistent with the source principle of taxation.

The problem remains, however, to determine the source of profit of a company operating in more than one province. Any allocation rules are essentially arbitrary. The compromise reached by the federal government and the provinces was, as indicated earlier, to weight sales and payroll equally. Sales were included because it was felt that payroll alone would allocate a disproportionate share of tax to the province where the firm's head office was located.[4]

To deal with the most important problem – avoiding double taxation of incomes – it is essential to have a uniform set of taxing rules. Provinces that are parties to the Tax Collection Agreements are required to accept allocation rules established by the federal government, as outlined above. For provinces outside the agreements, taxing practices initially diverged from the federal standard, but by 1962 all provincial jurisdictions generally adhered to common allocation rules.

The 1962 Tax Collection Agreements established the system that essentially is in effect today. Provinces could set their own tax rate as a proportion of basic federal tax, but they had to maintain the federal tax base and rate structure. Participating provinces were also allowed to enter or re-enter the corporation tax field.

In 1972, partial provincial control of the rate structure was achieved by the provision of federal administration of the tax credits against provincial income taxes. For personal income tax, at least, this was a significant departure from earlier policy. Prior to 1972, the progressivity of this tax was essentially determined by the federal rate structure.

Provincial Autonomy and Economic Efficiency

The evolution of the Tax Collection Agreements since 1941 has therefore been characterized by a progression of steps whereby the provincial governments have negotiated increased flexibility in employing income taxes as a means of achieving various provincial economic and social goals. The current arrangements have many desirable features. First, tax bases are relatively uniform across the country, making it possible to achieve economies in the administration and collection of tax revenue and also to minimize the compliance costs that taxpayers must bear. This is especially important for businesses operating in a number of provinces, which could well be required to keep eleven different sets of books if all governments had different tax systems.

A second notable feature is that allocation rules are uniform across all provinces with respect to both personal and corporate income tax. This is not completely the result of the agreements, however. It seems that all provincial governments appreciate the desirability of uniformity in these rules. Agreement on the assignment of bases to jurisdictions is sufficient to avoid the inequities of both double taxation and evasion of legitimate tax liabilities. The uniformity of taxing practices is laudable as well, because it avoids the economic inefficiencies that could otherwise result from the response of persons and firms to differences in tax rules that lead to significant differences in tax costs.

Even if tax bases are uniform and all jurisdictions employ the same allocation rules, however, problems relating to the allocation of resources can develop if there are significant differences in tax rates and tax burdens across the country that are not offset by differences in the flow of public service benefits financed by these taxes. The nominal tax rates applied to the basic federal tax on personal incomes by the nine provinces party to the Tax Collection Agreements as they pertain to personal income tax do differ markedly, as can be seen from Table 9-2. In addition, however, the effective tax rates also vary among provinces. This is partly because of the separate Quebec tax system and partly because of the varying abatements and credits applied by some of the provinces under the Tax Collection Agreements. The table also shows nominal provincial corporate tax rates, which for large businesses range from a low of 10 per cent in Prince Edward Island to a high of 16 per cent in British Columbia.

Table 9-2
Provincial Income Tax Rates, 1981

	Nominal tax rates[1]	
	Personal	Corporate
	(Per cent)	
Newfoundland	58.0	15-12
Prince Edward Island	52.5	10
Nova Scotia	52.5	13-10
New Brunswick	55.5	14-9
Quebec	...	...
Ontario	46.0	...
Manitoba	54.0	15-11
Saskatchewan	52.0	14-10
Alberta	38.5	11-5
British Columbia	44.0	16-8
Yukon Territory	43.0	10
Northwest Territories	43.0	10

1 Nominal rates differ from effective rates to the extent that the province concerned applies the special measures, and rates are shown only where tax bases are strictly comparable.

SOURCE The Honourable Allan MacEachen [Deputy Prime Minister and Minister of Finance], *Federal-Provincial Fiscal Arrangements in the Eighties*, a submission to the Parliamentary Task Force on the Federal-Provincial Fiscal Arrangements (Ottawa: Department of Finance, 1981); and certain more recent provincial tax changes.

The increased flexibility acquired by the provinces in establishing income tax rate structures led to a need to develop broad guidelines aimed at preventing the introduction of discriminatory measures that could reduce the efficiency of the Canadian economy. This goal is generally best served by treating residents and non-residents identically. To apply the principle of non-discrimination would involve, among other things, the prohibiting of differential treatment of resident and non-resident firms under the corporate income tax and the prohibiting of measures under the personal income tax that would create fiscal inducements to invest in one location over another.

Since provincial personal income tax is residence-based, differences in tax rates do not alter personal investment decisions.[5] An investor concerned with obtaining the best rate of return will allocate his portfolio across jurisdictions to maximize its gross return. But since personal income tax falls directly on personal income from property and employment earnings, the potential exists for migration of labour and capital to lower tax jurisdictions if the differences in tax burdens are not offset by benefits provided by government in the form of goods and services.

The provincial corporate tax, being source-based, falls on the capital income of all firms operating in a province regardless of whether the capital is owned by residents or non-residents. In a well-functioning capital market, profit-maximizing firms will allocate capital in such a way that after-tax returns are equalized across all jurisdictions in the long run. There will be a divergence between potential output and the actual output of the economy if this long-run allocation of resources between geographic areas differs from what it would be in the absence of any tax. This assumes, of course, that capital is relatively mobile. But if it is tied to a certain province because of locational advantages – such as proximity to markets or proximity to natural resources – then any favourable tax differentials available in another province must at least be sufficient to offset these advantages.

A great deal of the productive capital of the country is tied up in the way just described. There is, however, a large volume of "footloose" capital that, because of prevailing technology, can be located almost anywhere. In this situation, what is important is the relative cost of doing business in some locations as opposed to others. Such footloose capital would be expected to be responsive, among other things, to tax differentials in different jurisdictions. Some good examples would be the head offices of corporations or their research and development branches – where activities are characterized by the accumulation and processing of information. From the point of view of national economic efficiency, it is largely immaterial where such activities are located in Canada; hence the influence of differing provincial corporate taxes in determining location is not a matter of primary concern. To certain provinces, however, the resulting distribution of economic activity and of corporate tax revenues is obviously of considerable consequence.

Finally, it is important to note that the adverse effects of differentials in taxes on one factor of production depend in an intimate way on differentials in taxes on other factors. For example, since labour and capital are both needed in the production process, a personal income tax structure that attracts labour to one province will also tend to draw capital into that province, even if differentials in corporate taxes are non-existent.

Because fiscal power is centralized in a unitary state, the latter is in a position to institute taxation policies that can avoid misallocation of the economy's productive resources. Such a system, however, is usually taken to be constrained in its ability to respect differences in individual preferences for the mix and level of public sector outputs. A

federal system of government that is able to accommodate these differences can enhance the level of well-being of the nation's citizens. This is the essential justification for provincial autonomy with respect to revenues and expenditures.

It needs to be acknowledged, however, that the efficient allocation of capital and labour may not be the only goal of public policy; it may also be shaped by other priorities.

The Tax Collection Agreements can be seen to be concerned with efficiency in the allocation of the nation's resources to the extent that they contribute to generating equal net fiscal benefits among the provinces and to minimizing impediments to the free flow of factors of production. The contribution of the agreements to keeping administration and compliance costs at a reasonable level is also important. They do not represent a constraint on provincial autonomy given the fact that all provinces have the option to withdraw from the Agreements.

Although the Tax Collection Agreements have served the country well over a period of many years, they have more recently become a source of contention. The challenge is to preserve their desirable aspects but only to the extent that they accommodate an acceptable level of provincial autonomy. The discussion in the next section attempts to outline certain aspects of this trade-off as it relates to several recent provincial fiscal initiatives.

Recent Provincial Initiatives and Tax Competition

The increased flexibility that has been attained by the provinces in the field of income taxation has not prevented them from maintaining uniformity in important areas of taxation practice, whether or not they are parties to the Tax Collection Agreements. Indeed, it is easy to identify certain areas where provincial governments are well served by tax co-ordination. The reasons they agree to undertake such co-ordination are essentially the same as those which lead sovereign countries to enter into international tax treaties. At the very least, the latter incorporate principles of reciprocity and non-discrimination, the observance of which serves a common interest.

The provisions of the Tax Collection Agreements go far beyond those covered by typical international tax treaties, however – a fact that appears to have become a cause of growing dissatisfaction among the provinces with respect to certain provisions involving both personal and corporate income taxation. The main problem stems from the fact that some provinces, especially those with a large natural resource revenue base, feel unduly constrained in their use of provincial income taxes as instruments for creating a more diversified and prosperous provincial economy. Before considering this question, however, it is necessary to examine two other related irritants that are associated with the Agreements.

The Revenue Guarantee

An important implication that flows from the fact that provinces share the personal income tax base established by the federal government is that changes in the definition of the federal base can significantly affect the revenues of provinces participating in the Tax Collection Agreements. In addition, since provincial tax is levied as a percentage of basic federal tax, any change in the federal rate structure has a parallel impact on provincial tax yields. In order to offset partially any decrease in provincial revenues as a result of federal initiatives, Part IV of the existing arrangements provides a revenue guarantee to the provinces. Any province that is party to the agreements is compensated for losses in revenues from any structural changes in the federal personal income tax base or rate structure if the loss exceeds 1 per cent of the federal basic tax in the province. This revenue guarantee applies only in the first year after the federal tax change has been made.

Some provinces consider that the various deductions and exemptions from taxable personal income granted by the federal government – or so-called "tax expenditures" – excessively reduce the federal tax base and hence their own tax base. In addition, uncertainty about possible changes in the federal tax base may be an impediment to effective provincial government planning.

This problem could be avoided under the current fiscal arrangements by the provision of a full guarantee from the federal government against reduction in provincial revenues or by the restriction of federal government tax expenditures to the use of credits against federal tax rather than deductions from taxable income. For its part, the federal government must currently consider the impact of changes on provincial government revenues and on its payments under the revenue guarantee in the design of tax policy. The fact that the revenue guarantee is limited may bias federal choice in favour of deductions, as opposed to credits.

In the event that a decline in the tax base is initiated by the federal government, provincial governments can maintain their revenue yield by raising their own tax rates. From a technical point of view, however, this requires sufficient notice. Obviously, the change in tax rates may be unpopular. Moreover, the implications of the federal change in terms of equity

may not be in accord with provincial policy. The power of the provinces to counter these effects may be constrained by their limited control over the provincial tax rate structure. Even if they possessed complete flexibility in this regard, countering the effects might not be technically possible.

The existing revenue guarantee must be seen as a compromise to these conflicting interests. It is limited to one year, to allow the provincial governments time to adjust their own personal income tax legislation, if they so wish, without significant loss of revenue in the interim. A more generous guarantee was provided previously under the 1972 fiscal arrangements. In order to induce the provincial governments to incorporate the extensive federal tax reforms of that year in their own income tax legislation, the federal government undertook (originally until 1975 but eventually until 1977) to make up any shortfall in provincial income tax revenues, both corporate and personal, arising from tax reform. In the negotiations that led to the 1977 fiscal arrangements, this provision was replaced by the current revenue guarantee and by the transfer to the provinces of an additional percentage point of federal personal income tax, plus the cash equivalent of one percentage point.

If the tax base is to be shared and if the federal government is not to be unduly constrained in its use of the elements of the tax system in the pursuit of its own economic and social goals, the maintenance of a revenue guarantee to the provinces appears to be desirable. Indeed, it is probably necessary, to preserve widespread provincial acceptance of the Tax Collection Agreements. Of course, the specifics of any guarantee – including the extent of coverage and the term over which payments are to be made – are subject to negotiation.

The Administration of Provincial Tax Credits

As mentioned earlier, the federal government has been prepared since 1972 to administer certain provincial credits, abatements, and surcharges under the personal and corporate income tax system, subject to certain specified conditions. The intent, in the case of personal income tax, is to permit the provinces more flexibility in determining the impact of their overall provincial tax systems, particularly through the use of property tax credits and provincial retail sales tax credits. As spelled out recently by the federal Minister of Finance, the guidelines lay down three conditions considered necessary to preserve the objectives of the Tax Collection Agreements.[6] First, the measure must be administratively feasible. Second, the measure must not significantly alter, or have the potential to alter, the essential harmony and uniformity of the federal and provincial income tax systems. Third, the measure must not jeopardize the efficient functioning of the Canadian economic union by the erection of income tax barriers to normal interprovincial investment flows. The third condition has been the most contentious; it has been interpreted in such a way as to rule out any incentives that encourage residents of a province to invest in firms that undertake production primarily in that province and/or have their headquarters there. This interpretation would seem, despite the criticism, to be consistent with the principle of non-discrimination.

A problem arises, however, with the current system. Provinces that are not a party to the agreements are not bound by its provisions, and the principle of reciprocity may be violated as a result. For example, Quebec and Ontario, both of which administer their own corporate tax systems, have offered deductions and credits, respectively, for capital invested in small businesses domiciled in their provinces. British Columbia's Venture Capital funds, on the other hand, were ruled discriminatory by the federal authorities, which led to a threat by the province to withdraw from the Tax Collection Agreements.[7] Quebec also offers similar deductions under its own personal income tax system. British Columbia legislation establishing a 5 per cent tax credit for dividends received from companies with headquarters located in the province was also ruled discriminatory by the federal tax authorities. Ontario, a party to that part of the agreements pertaining to personal income tax, provides an outright grant for investment by resident individuals in accredited "Small Business Development Corporations," thereby avoiding the federal restrictions entirely, while maintaining the benefits afforded to that province by the Agreements.[8]

The Promotion of Provincial Economic Development

The provinces generally consider that personal and corporate income taxes, both of which are covered by the Tax Collection Agreements, provide important instruments for encouraging economic development within their boundaries. Alberta, in particular, is concerned that the depletion of the resources upon which its current growth is based poses a serious threat for its future. To forestall economic decline, the province has decided to utilize a portion of its current resource revenues to build a diversified industrial structure – for example, by offering incentives to selected industrial sectors, including tax cuts, deductions, and refundable tax credits. The provincial government has indicated that one of its goals is to encourage companies to locate their head offices in Alberta and to carry on a greater proportion of their

administrative and research and development activities there. Because the current agreements constrain the provinces in the use of such incentives or differential rates of taxation, Alberta has withdrawn from the corporation tax segment of the agreements and now administers its own corporate income tax system.

While the co-ordination of taxation under the agreements does not prevent the provinces from employing tax policy to promote economic development, the possible differentials in tax burdens between the provinces could have indirect implications for such co-ordination. Lower tax burdens on capital income in one jurisdiction can have several effects. First, by lowering the average tax on capital, they may induce further saving and investment. Second, the differential may entice capital to relocate from other jurisdictions – either other countries or other provinces. That is to say, provinces can manipulate the net fiscal benefits that accrue to the factors of production within their borders in an effort to increase the level of provincial economic activity. When such action is taken by one province, other provinces can be expected to react in the interests of preserving their own tax base. The general tendency, as recent examples illustrate, is for tax burdens to remain fairly uniform over time – the strength of this tendency depending upon the mobility of the factors of production that are subject to tax.

The status of estate taxation in Canada offers an interesting example. The Rowell-Sirois Commission found that multiple taxation of estates was common because provinces levied their taxes on the basis of both the prior residence of the decedent and the location of his assets. To overcome this problem, the Commission recommended that the provinces withdraw from the field of estate taxation. Under the Tax Rental Agreements that followed the Second World War, the provinces did withdraw from the succession duty field and were compensated, as in the case of income taxes, with per capita federal payments. The federal government entered the field of estate taxation at the same time. Under the 1957 agreements, 50 per cent of federal collections of succession duties in each province was returned to that province as part of the movement towards tax sharing. In 1964, the provincial share was raised to 75 per cent. Provinces outside the agreements pertaining to estate taxes received an abatement of the federal tax collected in their jurisdictions on the same percentage basis, or they received an equivalent cash transfer from the federal government.

Prior to 1972, British Columbia, Ontario, and Quebec levied their own estate taxes. As part of the overall federal tax reform of 1971, the federal government made capital gains that had accrued on assets taxable at death, but at the same time the government withdrew from the taxation of estates. Although six other provinces (all except Alberta) hastily entered the field, their use of the estate tax steadily declined, until by 1980 only one province (Quebec) still levied a tax on estates. As one observer remarked, "given the high mobility of wealthy individuals, a set of unco-ordinated and independent . . . provincial death taxes seems unlikely to be an important revenue source in any country."[9]

As mentioned earlier, Quebec and Ontario have maintained their own corporate tax systems for some years, consistent to a considerable degree with the federal definition of corporate taxable income, and have altered their own bases when the federal base changed. Moreover, corporate tax rates tend to exhibit significant uniformity across all jurisdictions and, again, tend to move together. Part of the explanation for the consistency of tax bases is found in each province's interest in minimizing the compliance costs of firms operating in two or more provinces. The explicit intention of tax rate uniformity is to avoid the loss of mobile capital to jurisdictions with lower tax burdens. If any province lowers the domestic tax burden on capital, it is in the interests of other provinces to follow suit.

The "tax competition" can thus result in reasonably harmonized tax burdens. Taxes, however, are not the only element that can be adjusted by provincial governments in an effort to attract capital investment by means of reducing costs. The provinces can also reduce costs to industry by undertaking expenditures for the purpose of providing a wide variety of supporting facilities and services for the benefit of business. The question that arises is whether competition of this sort is beneficial. With regard to the corporate tax in particular, does competition lead to a desirable sharing of the net burden of taxation between capital and labour?

There is no ready answer to this question.[10] On the one hand, it has been argued that mobility of capital – and the resulting demands on provincial resources to attract such capital – severely constrains the ability of the provinces to achieve the levels and distribution of services to the public that provincial governments would prefer. It has been contended by some that this competitive process among the provinces may result in a lack of sufficient revenues to fund the necessary public services. Each province would prefer to raise taxes to help finance needed expenditures, but each finds that its best interests lie in keeping its rates low no matter what the other provinces do. This argument contains a value judgment with respect to the appropriate size of the public sector. One could equally argue that provincial

tax competition provides a beneficial constraint on the growth of the public sector. A proper evaluation of the question would likely require construction of a detailed model indicating how the magnitude of public sector expenditures is influenced by the preferences of citizens.

On the other hand, any harmonization of provincial taxes and expenditure benefits brought about by interprovincial competition can have desirable effects, as indicated earlier. Moreover, a healthy rivalry between jurisdictions can generate efficiency in the provision of public goods and services.[11] The results, again, depend on the objectives of the provincial decision makers.

The kind of competition we have outlined can occur to a considerable extent within the confines of the present fiscal arrangements, with provinces using tax rates and expenditure policies as their primary instruments. In fact, the recent history of provincial taxes and expenditures can be interpreted as the outcome of just such a process of tax competition among the more wealthy provinces to attract capital investment within their boundaries. For its part, the federal government has developed regional policies, including programs of conditional and unconditional grants, to help the "have-not" provinces meet this competition without being forced to cut back their level of public services severely. The recent increase in fiscal disparities among all provinces caused by the increase in natural resource revenues accruing to a few provinces has put a strain on the relative stability of this competitive process, most directly because of the magnitude of equalization needed to maintain some reasonable balance in provincial fiscal capacity.

More indirectly, some of the provinces now see the corporate income tax in particular as being not just a source of revenue, but also an important tool for orchestrating the development of their provincial economies. They seek to do so by establishing different tax rates and other incentives for selected industrial sectors.

The above review is far from complete, of course, but it does serve to emphasize what is probably the most pressing problem facing the Tax Collection Agreements – the increased disparity in fiscal capacity among the provinces and the resulting implications for provincial development policies. The more richly endowed provinces may withdraw from the agreements if the latter do not provide the degree of flexibility required to enable them to pursue their development objectives. Moreover, this suggests that the withdrawal could become cumulative because other provinces may feel compelled to institute a separate tax system of their own in order to be free to establish comparable policies. Should such a development come to pass, many of the desirable features of the agreements would be sacrificed as well, including their contribution to economies in administration and compliance, as well as their influence on the maintenance of common allocation rules with respect to the taxation of income.

In this connection, the adoption of a "Code of Conduct," as suggested by some provincial governments, could serve a useful purpose. As proposed, it would complement the present agreements by defining acceptable behaviour in some, or all, of the areas of taxation or expenditure policy, regulatory activity, and procurement. Such a code should recognize the extent to which various policy instruments can be substituted for one another in order to achieve provincial objectives. Enforcement of the provisions of the code could take several forms, but the experience at the 1980 Constitutional Conference suggests that a constitutional provision that would be enforceable by the Courts would be unacceptable to many provinces. An alternative approach would be to entrust the policing of such an agreement to the provinces, with federal government support.

The above discussion has established two major points. The first is that a separate system of provincial taxes may well lead to significant differences in provincial tax structures with respect to the tax base, tax rates, and rules governing the allocation of taxable income. The second point is that the existence of different provincial tax systems could result in a misallocation of productive resources and a loss in economic efficiency.

With respect to the first point, it has been acknowledged that the provinces up to now have sought in certain important areas to co-ordinate tax policy either because they have had some incentive to do so or because they have been driven to that course by force of circumstances.

With respect to the second point, we earlier indicated some concern about the potential for fiscally induced migration and about the efficiency costs of such migration. There are several additional qualifications that should be noted. The first qualification relates to firms and their objectives. As a general rule, companies have an incentive to carry out their activities in those locations, and employing those technologies, which will result in the least cost to them after taking account of taxes. Even if there is a significant difference in the tax burden between two provinces that is not offset by other benefits, however, firms may seek ways to minimize the burden rather than relocate their production.

Through strategies such as incorporating in each province when tax rates differ and through choice of debt and equity financing, a firm can moderate the effects of the tax paid in each jurisdiction, as well as its overall tax burden. Moreover, if there is little co-operation between jurisdictions in the form of joint audits or other aspects of co-ordinated tax administration, the possibilities for tax avoidance and tax evasion are increased. Recent experience in the United States has shown that this avoidance or evasion can involve a significant amount of tax liabilities.[12]

Foreign Tax Provisions

The second qualification concerns the international dimension of taxation. The profits of the branch plants of foreign firms and the patriated income earned in this country by subsidiaries of foreign-owned firms are, in most cases, subject to tax in the country of domicile of the parent firm. The home country's tax provisions, especially with regard to the treatment of taxes paid in the host country, can determine to a significant extent the total tax burden on the income earned from the foreign investment. From a Canadian point of view, the U.S. corporate income tax law is particularly important.

In the interest of avoiding distortions in investment by U.S. firms, the U.S. corporate tax code grants a credit against U.S. tax payable on patriated foreign earnings of the tax levied at source in the host country, up to the total of U.S. tax owing. Foreign-source income and foreign taxes paid are, with few exceptions, aggregated on a worldwide basis. The result is that any credit surplus with respect to U.S. tax payable on income from any one country can be used to reduce the U.S. tax liability on the income from another country where the credit falls short of reducing the tax to zero. Any overall credit surplus can be carried forward. The intent of the U.S. law is to ensure, as far as possible, that all income earned by U.S. companies is taxed at the same domestic corporate tax rate.

These U.S. tax provisions have some significant implications. To the extent that the U.S. parent company of a subsidiary operating in Canada has an excess of U.S. tax payable on total foreign-source income over foreign tax credits (a "credit deficit"), any (small) change in Canadian federal or provincial corporate taxes will have no effect on the total tax liability of the parent firm in the United States. For instance, a tax cut by the federal government or one of the provinces would result in less tax being paid by the U.S. subsidiary in Canada but in an offsetting increase in taxes paid by the parent company to the U.S. Internal Revenue Service. The net effect is a transfer from the domestic (federal or provincial) Treasury to the U.S. Treasury. Since the tax change has no net effect on the firm, no locational incentives are created.

Recent empirical work suggests that U.S. companies operating in Canada tend to have a "credit deficit."[13] The U.S. law is rather complex and is currently in transition, but the broad implications are as follows. First, tax competition by provinces leading to lower tax burdens on U.S.-owned firms operating in Canada may not have the anticipated effects on the geographical allocation of capital. In effect, the U.S. Treasury harmonizes provincial tax rates for these firms. Second, a province pursuing a development strategy aimed at increasing the fiscal advantages of its jurisdiction must be more imaginative in using instruments other than reduced tax burdens. If it fails to do so, part of the incentive will end up as a foreign tax liability to the extent that the impact of the incentive affects U.S.-owned capital.

Crown Corporations

Numerous Crown corporations are at present engaged in business activities in Canada, and more may be established in the future. Performing a variety of functions and operating in numerous industries, Crown corporations are important instruments of economic and social policy at both the federal and provincial levels. Without gainsaying their usefulness in the pursuit of policy objectives, there exist several issues with respect to these public enterprises that should concern policy makers and citizens. Many of these issues touch directly on the subject matter of this report. Included in this list would be the role of public enterprises in economic development, the implications of their taxation status, and the implications of the activities of Crown corporations for intergovernmental fiscal arrangements, especially the Equalization Program. In earlier chapters, we indicated the need, in the case of an equitable and efficient equalization scheme, to account for the fiscal benefits accruing to the residents of the various provincial jurisdictions through the pricing policies of provincial enterprises. Some of the same considerations arise with respect to the areas discussed below, although in this chapter we can only indicate the nature of these concerns.

Some provincial Crown enterprises, especially the electric utilities, have been explicit instruments of provincial development policy. Electric utilities were among the earliest provincial Crown corporations. By providing ample supplies of power at the lowest possible rates, provinces hoped to attract industry to their jurisdictions. To this end, most Crown corporations were established to undertake the production

and distribution of electricity or to take over the operations of private owners. The utilities were aided in achieving the lowest possible financial costs by two provincial policies. First, the public owners, unlike private owners, did not demand a market rate of return – or, indeed, any return – on their equity investment; the corporations were simply required by legislation to recover their financial costs. Second, the cost of debt capital to the utilities was kept low through direct borrowing by the provinces or through provincial guarantees backing the debt of these utilities.

The tax treatment of Crown corporations engaged in business activities is also a serious concern. Section 125 of the BNA Act states that "no Lands or Property belonging to Canada or any province shall be liable to taxation." In practice this has meant that Crown corporations created at one level of government are exempt from paying taxes levied by the other level of government, or by other governments at the same level.

In reality, some payments are made. For instance, many federal and provincial departments and enterprises make grants in lieu of property taxes to municipal governments. In addition, Part VIII of the Fiscal Arrangements Act enables the federal government to enter into reciprocal taxation agreements with the provinces, under which both levels agree to pay each other's sales taxes. At present, the six provinces east of Manitoba have entered into such agreements with the federal government.

There are no intergovernmental agreements with regard to the payment of income taxes by Crown corporations. This tax exemption provides an incentive for governments at both levels to take over profitable private corporations. By following this course, the new public owners are able to appropriate the income tax revenue otherwise payable to the other level of government.

Although the potential exists for the erosion of the corporate tax revenue of each level of government, the problem is more acute for the federal government in view of the fact that it collects 70 per cent of corporate income taxes.

The nature of these problems has been apparent for some time. In the debate surrounding the expropriation of several private electric utilities by the Quebec government in 1944, the province noted the apparent inequity in the fact that a portion of revenue from electricity sold by these companies was used to pay federal income tax, whereas in Ontario prices were lower because the provincially owned utility was exempt from federal taxes.

To encourage neutrality in the tax treatment of public and private utilities, in 1947 the federal government offered to transfer 50 per cent of the federal corporate tax revenues collected from privately held utilities to the provinces. Currently, under the Public Utilities Income Tax Transfer Act, the federal government turns over to the provinces 95 per cent of federal corporate income tax collected on private corporations involved in the distribution, or generation for distribution, of electricity, gas, and steam to the public. Estimated payments to the provinces under these provisions for the fiscal year 1980/81 were $72 million.[14]

Since it is not possible for the federal government to shield all private companies in this way if the expansion of provincial ownership is considered undesirable, one remedy would seem to be to make Crown corporations taxable either by agreement or by constitutional amendment.[15] It must be acknowledged, however, that defining the taxable income of Crown corporations would present difficult problems in view of the fact that, unlike private corporations, earning a return on investment may not be a primary concern in the operation of these businesses. Thus, as in the case of the provincial electric utilities, the federal tax could be avoided by charging prices to consumers that would not provide a reasonable rate of return on invested capital. Ironically, without a careful definition of the tax base, making these types of public enterprises liable for tax could actually generate increased takeover of private companies, after which a province could convert them to non-profit status by offering their services to residents at subsidized prices.[16] In addition, since the public enterprises may have preferential access to capital markets because provincial governments guarantee their debt, taxable profits could be reduced significantly by increases in the firm's debt/equity ratio. Alternatively, a province might be able to impose special taxes on these enterprises that (if deductible in the determination of taxable income) could also reduce their federal tax liability. All these considerations suggest that, if neutrality between public and private sector enterprises is the objective, it would be necessary to develop special rules to impute a tax base for Crown corporations if they are to be taxed on the same basis.[17]

Finally, interpretation of section 125 of the BNA Act has assumed considerable importance in the context of federal-provincial competition for the revenues derived from taxation of natural resources in the provinces. Of particular importance are the massive revenues from the production of oil and gas in the West.

Understandably the provinces involved consider the rents generated from the exploitation of the natural resouce riches situated in their jurisdictions as their own property. The federal government has also been determined to capture some portion of these rents through the tax system by the use of two devices. The federal Petroleum and Gas Revenue Tax, and the Natural Gas and Gas Liquids Tax, under the National Energy Program, both of which were designed to raise revenues for the federal government, were viewed by the producing provinces as an actual or potential tax on their Crown property. A ruling by the courts in favour of the provinces with respect to either of these tax measures would imply that they could shelter their oil and gas revenues from federal taxation under the umbrella of Crown corporations.

To complicate matters, a province may wish to use the instrument of a Crown corporation for reasons other than merely to escape federal tax. Measuring rent is a complicated affair and given that the concept tends to possess the characteristics of a residual, a Crown corporation might be an efficient tool by which to collect these rents, either at the production stage or at some intermediary stage between the producer and the purchaser. Some provinces consider their taxation powers as insufficiently refined fiscal instruments for exercising their provincial rights over natural resources to best advantage. In addition to this technical question, there are constitutional constraints on the use by provinces of potentially efficient tools – particularly the use of what have been interpreted by the Supreme Court as indirect taxes – that may favour the use of public enterprises. The point is that making provincial Crown corporations subject to federal tax may have the effect of confining the provinces to the use of inferior fiscal tools.

The issue of dividing revenues from oil and gas production between the federal government and the governments of the producing provinces has been resolved for the next five years as a result of the recent energy pricing agreements between the federal government and the western provinces. While some of the constitutional issues remain unresolved, it has been demonstrated that revenue-sharing agreements can serve to sidestep some of the difficult legal issues involved in the taxation of Crown corporations.

Conclusions

National economic efficiency is enhanced to the extent that the impact of the policies and programs of government is neutral in determining the allocation of resources across the country. It follows from this conclusion that equality of net fiscal benefits between provinces is one factor necessary to promote efficiency in the Canadian economy. The tax system, in turn, constitutes an important element in the determination of the net fiscal benefits that shall accrue to residents; consequently it also has important implications with respect to the goal of economic efficiency.

In a federal country, the income tax system should take account of the need to maintain neutrality in its impact on resource allocation by avoiding double taxation and other discriminatory measures. In addition, the tax system should also aim at achieving other subsidiary goals. When two levels of government in a federal country tax the same income and when individual persons and firms earn income in several provinces, it is desirable to devise a system that will minimize the cost of compliance for taxpayers and the cost of tax collection for governments and yet will enable the governments involved to maintain a high degree of individual autonomy.

Over the years, the Tax Collection Agreements have made an important contribution towards the realization of these goals. Since 1941, we have shifted from complete centralization of personal and corporate income taxes to a much more flexible sharing of income taxes between federal and provincial governments. The increased flexibility that has been attained by the provinces in designing their income tax systems has not prevented them from maintaining uniformity in important areas of taxation practice, whether or not they are parties to the Tax Collection Agreements. All provinces agree to rules governing the allocation of individual incomes and corporate profits for purposes of provincial levies, and these rules provide for the fair taxation of income. Broad conformity to the definition of the tax base helps prevent the sort of "tax jungle" problems that arose in the 1930s in Canada and that currently exist in other federal states.

Provinces that are party to the agreements have achieved significant flexibility in establishing tax rates and rate structures designed to achieve their provincial goals. The cost savings to the provinces as a result of the federal absorption of collection and administration expenses seem to compensate them adequately for their lack of autonomy with respect to their tax bases. Some provinces, however, have recently expressed concern about significant and unanticipated changes in the definition of the tax base by the federal government. Any negative impact of such changes on provincial tax revenues is partially offset by a federal guarantee. Some such guarantee seems to be desirable when tax bases are shared and when the federal government has unilateral control over the definition of those bases.

Although the agreements with respect to personal income tax appear stable, this is also the area where the economic costs of establishing separate systems are usually thought to be relatively small in terms of the potential impact on resource allocation. Increased provincial flexibility in the rate structure of personal income tax can probably also be accommodated at small cost. The introduction of discriminatory provisions, however, should not be condoned on either ethical or economic grounds.

Significant provincial co-ordination of taxation can co-exist with an aggressive provincial development policy. The present agreement with respect to corporate income tax does not prevent provinces from using taxation rates as a primary tool for promoting economic development. In the case of some provinces, however, this is not a preferred instrument for economic development. In particular, it does not allow tax burdens to be differentiated by industrial sector.

Any province's development strategy, if it is to be effective, will operate to some extent at the expense of other provinces. In this respect, a Code of Conduct, agreed to by all provinces, would seem to be a desirable development. The virtue of such a code lies in its ability to address concerns outside the scope of the present Tax Collection Agreements, including the more volatile corporate tax rates, provincial expenditures aimed at attracting industry, and the entire range of regulatory measures enacted by provinces. Establishment of a Code of Conduct to govern these areas would serve the mutual self-interest of all provinces.

10 The Politics and Process of Fiscal Arrangements

The purpose of this chapter is to evaluate the politics and the process involved in the review of the fiscal arrangements at five-year intervals. This regular review by the federal and provincial governments plays an important role in determining the nature of the programs in the fiscal arrangements. The evaluation is based broadly on three different concerns:

- the democratic character of the review in terms of its level of openness, participation, and accountability;
- the effectiveness of the policy making in the review, including how it defines issues for the public realm, what degree of conflict is involved, and whether "indiscriminate" growth of governments has been found in the process; and
- the consistency of such an intergovernmental review with the principles of Canadian federalism in the sense of the role of each level of government and of the balance of power among governments in the federal state.

On the basis of these concerns, we conclude that, on balance, the process has been quite successful to date. In our view, it has facilitated a considerable amount of consultation, co-operation, and compromise among governments. Nevertheless, our analysis has identified certain shortcomings in the review process that deserve consideration.

The Quinquennial Review of the Fiscal Arrangements

To a considerable extent, the Canadian political system functions in response to the continuing interaction of government officials and institutions. Canada's federal system is noted for the innumerable intergovernmental conferences and meetings, which often involve national policy making and policy co-ordination. These methods of intergovernmental liaison have developed mostly as a practical response on the part of policy makers to their political and economic environment. In addition, since formal amendment of Canada's Constitution is extremely difficult, these committees and conferences are characterized by a high degree of flexibility in terms of structure and organization, and by the lack of any formal constitutional justification.

An integral part of this complex intergovernmental web is the review of the fiscal arrangements every five years by the federal and provincial governments. These reviews involve a broad examination of the major issues affecting the fiscal arrangements by a number of intergovernmental committees, ranging from professional-level bureaucrats to the First Ministers themselves.

In this section, the formal nature and the actual operation of these reviews are described in some detail. To begin, it may be helpful to outline the development of intergovernmental relations in Canada. This historical background establishes the setting for analysing the nature and the operation of the intergovernmental review of the fiscal arrangements.

The Development of Intergovernmental Relations

When the Fathers of Confederation set out the principles of the Canadian nation in the British North America Act of 1867, they made a concerted effort to divide the powers and functions of each level of government into watertight compartments.[1] Nevertheless, the need for some co-operation and consultation among governments quickly emerged in Canada. In the early years, provincial demands for changes in federal financial subsidies necessitated intergovernmental contact. At the same time, the federal government quite freely exercised its powers of disallowance and reservation in an attempt to control the provincial governments.

Between 1867 and the Second World War, however, the kinds of governmental interaction were limited. Under the prime ministership of Sir John A. Macdonald, the role of the provincial lieutenant-governors, as appointees of the federal government, was to facilitate collaboration and communication between the provincial and federal governments. In

large part, Prime Minister Macdonald assigned that role to the lieutenant-governors as a means of maintaining a strong central government and minimizing direct contact between federal authorities and the provinces. In contrast, the provinces, which were intent on asserting their autonomy, objected strongly to the role delegated to the lieutenant-governors. This friction led to a series of *interprovincial* meetings between 1887 and 1926, at which the provinces pressed their claims on the federal government, even though the latter did not accord them any formal recognition.[2]

Following the First World War, the first signs began to emerge of the new responsibilities that were to be assumed by governments over the course of the present century. These responsibilities cut across many of the jurisdictional lines laid out in 1867, especially in the area of social legislation. The federal government introduced the Technical Education Act in 1919 and the Old Age Pensions Act in 1927. In both cases, the federal government sought to act in areas that had hitherto been considered a provincial responsibility, in order to achieve national goals. These programs, in turn, created a need for further contact between the two levels of government. These contacts were further broadened during the Depression of the 1930s as a result of the compelling need that developed for federal assistance to the provinces to deal with critical social problems of mutual concern, particularly in the case of provinces that lacked sufficient resources to cope on their own.

In these circumstances, the intergovernmental processes were very much *ad hoc*; they have been described as "a very large number of makeshift intergovernmental arrangements to meet the urgent needs of individuals and families."[3] Yet, despite the *ad hoc* character of intergovernmental affairs in the 1930s, a series of formal *federal-provincial* meetings of First Ministers, under Prime Ministers Bennett and King, were held for the first time. The meetings were also the beginning of continued intergovernmental contact at the bureaucratic level. These contacts were strictly confined to the particular problems being dealt with by the federal and provincial governments concerned.[4]

Between the end of the Second World War and the mid-1960s, governments became increasingly committed to economic policies aimed at full employment, growth, and trade liberalization, as well as to development of a wide range of social policies. The federal government initiated the establishment of a national social security and health insurance system. An integral part of these developments was the introduction, over a number of years, of the equalization and conditional grant programs that are now included in the Fiscal Arrangements Act of 1977. (There are, of course, a number of other federal-provincial programs provided for under separate statutes.)

The result was a phenomenal growth in intergovernmental liaison. An elaborate system of intergovernmental relations evolved with meetings and contacts at all levels of government. The number of formal federal-provincial conferences nearly doubled from 64 in 1957 to 125 in 1965. Many other *ad hoc* committees were established from time to time.[5]

Since the mid-1960s, there has been continued but somewhat slower growth in the number of intergovernmental committees. Nevertheless, where mechanisms of intergovernmental relations were already in place, there appears to have been a tendency for them to become increasingly complex, both with respect to the matters at issue and the number of government ministries involved. Perhaps the most dramatic evidence of this trend has been the establishment in the federal government and in almost all provincial governments of special departments or offices for the specific purpose of monitoring developments and devising strategies for dealing with federal-provincial issues.

This trend towards greater complexity in intergovernmental affairs is, in part at least, a result of the increasing sophistication of provincial governments. No longer is the federal government the singular force that it was during, and immediately following, the last war. During that period, federal authorities employed their political and financial power to put in place the major elements of Canada's social welfare system, despite questions of their jurisdiction in such areas as health, education, and social assistance.

But the once-dominant position of the federal government appears to have been considerably reduced in the intervening years, which is evident from the substantial growth in the provincial-local share of all governments' expenditures (after federal grants and transfers). In 1958, the federal government accounted for 55 per cent of final expenditures by all governments, compared with 45 per cent for the provincial-local sector. By 1978, the relative shares had been more than reversed, the provincial-local sector accounting for 60 per cent of final expenditures and the federal government for 40 per cent. This reversal underlines the extent to which the provinces have extended their power, the effect of which is important for intergovernmental relations.[6]

The Formal Nature of the Quinquennial Review

Traditionally, the federal and provincial governments have consulted each other every five years on proposed changes to the fiscal arrangements. When the Tax Rental Agreements were first established during the Second World War, they extended for the duration of the conflict, plus one year. Following the war, governments decided to continue these agreements on a five-year basis. When the Tax Rental Agreements became part of the peacetime "fiscal arrangements" in 1947, the practice of a quinquennial review was firmly established in the legislative enactments of both federal and provincial governments.

Since the fiscal transfer programs under the arrangements are provided through federal legislation, the provinces have very limited formal power to affect the content of the Act. If the federal government chooses to resist or ignore their representations, it can do so.

In the present Fiscal Arrangements Act, statutory requirements limit only to a minor degree the federal government's options. The section dealing with equalization is consistent with the practice of a five-year review insofar as the program terminates as of March 31, 1982. Similarly, with the transformation of the shared-cost programs in health and postsecondary education to the present form of Established Programs Financing in 1977, it was agreed that the federal government could modify these arrangements in any way short of termination as of April 1, 1982. Prior to that date, amendments could be made by the federal government provided they did not reduce any province's entitlement. After that date, if termination were to occur, three years' notice had to be given by the federal government to the provinces.[7] Subject to these limitations, the federal government is legally free under the Act to introduce legislation pertaining to the programs regardless of provincial views.

To understand the nature of "bargaining" involved in the quinquennial review, it is necessary to understand the nature of the provisions laid down in the federal legislation. The federal-provincial discussions that precede any revision of the fiscal arrangements have become an established practice, but they are not mandatory under the Act. The consultation that takes place as part of the review of the fiscal arrangements leads ultimately to a *federal* decision. This feature is underlined by the fact that while customarily there is a broad review of fiscal arrangements every five years, prior to the introduction of a new statute, the federal legislation can be, and has been, amended between reviews and before termination of the Act. A recent example was the introduction by the federal government, prior to the current negotiations, of amendments to equalization that limited the amount of resource revenues calculated under the formula and disallowed Ontario's equalization payments by means of a "personal income override."

Although the formal powers of the federal government are great under the federal Act, the provinces can take initiatives on related tax and expenditure policies between reviews. For example, Alberta elected to withdraw from the corporate tax collection agreements, effective in 1981, in accord with the provisions of the federal legislation. In addition, the provisions of Established Programs Financing allow the provinces to determine to a large extent how federal transfers will be spent.

In general, it is in the area of tax harmonization that the provinces have the most tangible amount of leverage for bargaining with the federal government during the reviews of the fiscal arrangements. Under the Tax Collection Agreements, provinces have threatened not to participate in various ways, ranging from complete withdrawal to partial participation. Indeed, Quebec does not formally participate in these Agreements, while Ontario and Alberta have followed variations of these approaches, most notably by electing to levy and collect their own corporate income taxes.

In the other areas that rest primarily on federal financial power, the provinces' bargaining strength depends largely on political and moral suasion. Despite the intangible nature of this kind of suasion, the effects are *real*. For example, certain provinces, especially Quebec, have protested against the federal government's use of its spending power to shape programs under the fiscal arrangements that they consider involve areas solely under provincial jurisdiction. Some have also argued strenuously against the "conditionality" of shared-cost programs. The federal government has responded in a substantive way to some of these objections. It initiated a plan of "opting out" for Quebec and other provinces in 1964, and it proposed a scheme of "block grants" in 1970-71 which eventually culminated in the Established Programs Financing system that began in 1977.

The Process of the Quinquennial Review

Testimony to the very real influence wielded by provincial governments during the course of the quinquennial review of the fiscal arrangements is provided by the elaborate process that has developed for federal-provincial consultations. In these

complex intergovernmental operations, who participates, when, and how, significantly affects the nature of the programs under the fiscal arrangements.

At the outset, it is important to understand that there are many variables in each set of negotiations, perhaps the most important being the particular political and economic climate prevailing at the time.

The current round of negotiations on the fiscal arrangements is taking place against the background of the bitter debates that preceded it on fundamental issues involving constitutional and energy issues. These issues have involved a number of matters that are closely interrelated with the federal-provincial fiscal arrangements. The treatment of natural resources in the Equalization Program, for example, cannot easily be separated from decisions with respect to energy pricing or the sharing of oil and gas revenues. The constitutional debate has also involved issues relevant to the fiscal arrangements, including constitutional entrenchment of equalization, questions of "power over the economy," tax harmonization, and the preservation of the Canadian common market. Moreover, the bargaining process may have been made more difficult by the strains in the political environment caused by the earlier impasse over constitutional reform and energy policy. All these factors are combined with a current economic environment that is marked by relatively poor past performance and future prospects, the effects of which are dramatized by the present budget position of the federal government and its claim to be the victim of a fiscal imbalance.

Other variable elements of the process include the participants themselves and the nature of the major issues under consideration at any given time. The actual number of participants in the fiscal arrangements is quite small. Indeed, Professor Donald V. Smiley of York University has described the major participants in federal-provincial affairs as members of a small club.[8] As a result, changes in principal actors may have considerable consequences for the bargaining process. Also, the nature of the process often depends on the issue or problem under consideration. In 1977, for example, when the financing of medical care, hospital insurance, and extended health care was being considered as part of the proposed Established Programs Financing arrangements, members of the Department of Health and Welfare Canada and their provincial counterparts were also actively involved in the negotiations.

Despite these constantly changing dimensions, there are identifiable common elements in the process. As the end of each five-year period for the fiscal arrangements approaches, usually in the second last remaining year, the federal Department of Finance initiates informal bureaucratic consultations and then goes on to prepare an initial position and a proposed agenda for negotiations. Its preparations are subject to scrutiny in federal Cabinet through the Priorities and Planning Committee. As the initial federal position and agenda for negotiations are being set, the provincial Finance Ministers similarly establish their positions, also with the approval of the Cabinets of each province. These provincial positions are usually in the form of a response to actual or anticipated federal initiatives. The Cabinets of all governments may be called upon at various stages of the negotiations to approve changes in the position of the governments, even though normally they are only asked to approve the contents of the new legislation after the negotiations have been completed.

The main committees of Ministers and Deputies that prepare for, and carry out, the negotiations are those which also serve to conduct the exchange of information and views on fiscal and economic affairs in general. They are the Committee of Finance Ministers and the Continuing Committee of Officials on Fiscal and Economic Matters.

The annual meetings of Finance Ministers to consider the economic and fiscal outlook have been held regularly since 1964. Frequently in the past, the meetings occurred in January or February so that all governments could use the discussions as background for Spring budgets; however, now that the federal government appears to favour Fall as the more usual budget time, these meetings have more recently taken place in October.

The Continuing Committee of Officials on Fiscal and Economic Matters was first established in 1955 to prepare the federal and provincial governments for negotiations on the fiscal arrangements.[9] It has met frequently since that time, often to deal with such *ad hoc* issues as tax reform in 1972 and the prices and incomes control program of 1975. Meetings are called as required, but they now occur at least twice a year. The Committee itself consists of the federal Deputy Minister of Finance, plus the Assistant Deputy Minister responsible for federal-provincial relations, together with members from each of the provinces. The provincial members customarily include the Deputy Minister of Finance and other officials as required. Observers from other federal and provincial departments or agencies attend as required.

One of the yearly meetings of the Committee usually considers the background information for the annual meeting of the Finance Ministers. Current issues of an economic or financial nature are frequently reported on and discussed – for example, wage and price controls, conditional grants, tariff negotiations, and banking legislation. To prepare for

this meeting, there are two subcommittees of officials that meet regularly, one on Economic Data and one on Fiscal Data. Each year they produce the "Green" and "Brown" Books. These books review and analyse the newly revised data on economic performance and fiscal policy. The books are used in discussions as background information at meetings of the Continuing Committee and of the Finance Ministers.

When it comes time to review the fiscal arrangements, meetings are usually more frequent and the Continuing Committee discusses the problems involved. These discussions are assisted by the work of a series of subcommittees of the Continuing Committee. Currently these include a co-ordinating subcommittee on Fiscal Arrangements, and technical subcommittees on Equalization and on Tax Collection. These subcommittees consist of officials below the deputy minister level, usually those with direct responsibilities in the areas under scrutiny.

While the Continuing Committee plays an active role in laying the groundwork for negotiations, most of the negotiations themselves are conducted by the Finance Ministers. Negotiations among these Ministers can take place either at their annual meeting, where several economic issues might be discussed, or at *ad hoc* meetings called specifically to consider the fiscal arrangements and related issues. The First Ministers participate, if at all, in the final stages of discussion only. First Ministers' meetings were called to resolve the outstanding issues in the 1972 and 1977 negotiations.

While Ministers of Finance, First Ministers, and officials from the Departments of Finance are the major participants, other Ministers and officials also become part of the negotiations according to their responsibilities. The Department of Health and Welfare Canada and its provincial counterparts, as discussed earlier, participated in the negotiations in 1977 on the creation of the Established Program Financing arrangements. Similarly, the Secretary of State and the provincial Departments of Education may be called upon to participate because of roles relating to postsecondary education. In addition, the Bank of Canada has sent observers to the negotiations to contribute information and to assess the implications of changes in the fiscal arrangements for monetary policy. Last but not least, the intergovernmental bureaus such as the federal government's federal-provincial relations office (which now has its counterpart in almost all of the provincial governments) bring a global perspective to negotiations, ensuring that the concerns of the Ministers of Finance are in line with the broad jurisdictional/institutional positions of the governments concerned.

The negotiations and the operations of the various intergovernmental committees reflect an important division of responsibilities between bureaucrats and executives of the eleven governments. Since there are many decisions of a political nature involved in any review of the fiscal arrangements, the politicians, as executives of the government, are those most actively engaged in the actual bargaining and decision making. Professor Richard Simeon of Queen's University has captured the responsibilities of the bureaucrats by describing the Continuing Committee in the following way:

> [It] is therefore an important element in fiscal negotiations. It does not eliminate conflict, but does affect the nature of the negotiations by bringing many of the participants into close and continuing contact, and by improving the flow of information. It lessens misunderstandings, and by providing objective data makes for more objective debate.[10]

The process of reviewing the fiscal arrangements reflects many of the attributes of Canadian intergovernmental relations. The reviews involve examination of a wide range of important national issues by a number of intergovernmental committees. With no formal status in the Constitution or in law, these committees have a flexible structure but a permanent nature. The responsibility of executives of government for actual decision making in these matters is great. Further, while there are few statutory limitations on the power of the federal government to amend legislation involving the provinces without their consent, in practice provincial governments are in a position to wield substantial political power of their own throughout the process of negotiations over federal-provincial fiscal arrangements.

The Review of the Fiscal Arrangements: An Evaluation

This section is concerned with examining and evaluating the character and the operations of the fiscal arrangement reviews. The starting point of the evaluation is the serious misgivings raised by certain observers and practitioners about the general nature of intergovernmental affairs in Canada. While these criticisms have primarily been made about intergovernmental relations in a general way, applying them to the fiscal arrangements provides important insights into these arrangements. At the same time, this analysis indicates the extent to which the particular intergovernmental processes in the reviews of the fiscal arrangements are consistent with democracy and federalism in Canada.

Executive Federalism: Democracy and Efficiency

The processes associated with intergovernmental relations in Canada have been given various labels in an effort to describe their nature. "Co-operative" and "collaborative" are two terms that have been applied. They underline the fact that effective policy making in a host of areas in a federal state, from social policy to national economic development, requires the harmonization of federal and provincial programs and the use of policy instruments at both levels. These processes have also been called "executive federalism" because the main participants are senior bureaucrats and cabinet ministers. Political parties and legislatures play a minor role in intergovernmental accommodation. And these processes have been described as "federal-provincial diplomacy" because of the similarity between them and the conduct of international relations."

Those who follow the conduct of intergovernmental affairs in Canada often stress the kind of "executive federalism" that dominates intergovernmental relations in the country, as well as the role of senior politicians and administrators in decision making. From this vantage point, they often identify two underlying concerns relating to the democratic character of the process and the effectiveness of policy formulation. These very general criticisms have perhaps been most succinctly described by Professor Donald V. Smiley,

> First, it [executive federalism] contributes to undue secrecy in the conduct of the public's business. Second, it contributes to an unduly low level of citizen-participation in public affairs. Third, it weakens and dilutes the accountability of governments to their respective legislatures and to the wider public. Fourth, it frustrates a number of matters of crucial public concern from coming on the public agenda and being dealt with by the public authorities. Fifth, it has been a contributing factor to the indiscriminate growth of government activities. Sixth, it leads to continuous and often unresolved conflicts among governments, conflicts which serve no purpose broader than the political and bureaucratic interests of those involved in them.[12]

The two concerns of democracy and effective policy making are evident in this critique. The first three points raise the question of how democratic the processes of intergovernmental relations are – specifically the level of openness, participation, and accountability in executive federalism. In contrast, the last three criticisms concern the effectiveness of policy making in the sense that the criticisms of Professor Smiley relate to the output of intergovernmental relations – the kinds of policies generated and the ability of governments to serve the needs of their citizens.

Does the process of reviewing the fiscal arrangements every five years justify these criticisms directed at intergovernmental affairs in general? The objections concerning the democratic character of the process will be dealt with separately from those concerned with the effectiveness of policy making.

Both observers and practitioners alike have cited the undemocratic nature of the process through which these fiscal arrangements have evolved. Professor Thomas Courchene said of the 1977 legislation concerning the fiscal arrangements:

> . . . the entire renegotiation process with respect to the new fiscal arrangements essentially by-passed the Parliament of Canada. It is true that the Fiscal Arrangements Act is an Act of Parliament. But our federal representatives were effectively presented with a *fait accompli*, hammered out between representatives of Ottawa and the ten provincial governments. The bulk of the Commons debate on the bill was directed toward sorting out the precise details of its various provisions. There was no debate in the traditional sense of the term. This raises the important issue of whether the institution of the federal-provincial conference is serving adequately the needs of the nation. Public opinion was not brought to bear on the new arrangements . . . .[13]

Similarly, the Right Honourable Joe Clark, Leader of the Opposition, stated in the House of Commons debate on the legislation in 1977:

> We are faced with . . . a *fait accompli* . . . agreement arrived at by heads of government meeting away from here without allowing Parliament so much as an expression of opinion with regard to the options . . . .[14]

The process associated with the development of the fiscal arrangements seems to warrant these criticisms. It involves consultation among bureaucrats at one level and decision making by the executive branch of governments at another. Generally, neither the consultation nor the decision making has been subject to any significant degree of scrutiny by Parliament, the press, or affected groups. Moreover, the major participants are relatively few, and their specific interests are largely confined to their general responsibilities as members of Departments of Finance.

Consideration of these criticisms should take into account the various types of intergovernmental relations involved in the fiscal arrangements. Professor J. Stefan Dupré of the University of Toronto, when discussing intergovernmental affairs in general, made a distinction that is relevant here:

> To make sense of the question of openness and accountability, I consider it essential to distinguish

> sharply between government by conference at the summit and government by conference at the functional or operating level . . . . I am struck by the glare of publicity that has come to focus not simply on the personalities but on the issues that summit conferences involve. I am also impressed by the leap in the quantity and the quality of publicly released discussion and position papers. There is an ever-growing contrast between the openness of government by conference at the summit within individual governments, and the cloak of secrecy that surrounds cabinet within individual governments. As for accountability to Parliament and to provincial legislatures, there is evidence that there has been a substantial increase in the attention accorded to summit matters in question period and by legislative committees . . . .
>
> On the other hand, where I believe the conventional wisdom about secrecy and non-accountability remains relevant is in the other eight-ninths of the iceberg that is government by conference – the hundreds of murky committees and structures where operational and functional matters are at stake.[15]

Based on this type of distinction, what tends most of all to contravene the principles of openness, public participation, and accountability are the "murky committees and structures where operational and functional matters are at stake." Participants in the process have been among the first to acknowledge that the increasing complexity of intergovernmental fiscal and economic relations has led to a proliferation of "*ad hoc* committees and technical subcommittees of a more or less permanent nature."[16] It seems quite fair to say, therefore, that the intergovernmental committees of bureaucrats involved in the fiscal arrangements reflect a degree of "murkiness." This murkiness exists in the sense that the committees are characterized by a flexible structure and organization, with many being struck according to need. This is so, despite the permanent character of these committees in the process as a whole.

At the same time it is no doubt true that as the fiscal arrangements become the subject for negotiation at the executive level, they are subject to more scrutiny and public awareness. In fact, with respect to the fiscal arrangements, it seems that it is only at this point that any real awareness of the process develops in Parliament, in the press, or among the public.

To a considerable extent, this is understandable since at the bureaucratic level there is primarily only consultation and exchange of information. In contrast, at the executive level it is a question of actual decision making. There are differing degrees of scrutiny and public awareness required at the two levels. At the bureaucratic level, the need is mostly for scrutiny of information in order to ensure that a limited number of the public and certain affected groups are as informed as possible. As for the actual decision making by the executive, there are larger concerns and a wider public. Naturally, more often than not, greater attention is paid to this process.

In this context it should be stressed, however, that the negotiations on the fiscal arrangements at the executive level certainly have not become as open as Professor Dupré suggests. The type of open and accountable intergovernmental process to which he referred is much more consistent with the First Ministers' Conferences on the Constitution and on the economy. These conferences aroused considerable demand on the part of the public and the press for an open process of consultation – a demand that produced positive results, with numerous discussion and position papers being made available. Moreover, most of the sessions were televised in whole or in part. The complexity and the technical nature of the negotiations on the fiscal arrangements, however, along with the primary roles being played by Finance Ministers rather than First Ministers, explain in part why the process of review has not, as yet, been subject to as much pressure for greater openness in decision making. It is simply not such a "media event."

While the process of reviewing the fiscal arrangements is not comparable in openness to First Ministers' meetings, especially given the glare of television lights at First Ministers' conferences, steps taken recently have resulted in a more open and accountable process. Some of the provinces released an abundance of information and position papers prior to the current review; interesting examples are the papers on this subject in the recent Ontario and British Columbia budgets. In addition, the federal government instituted a major innovation with the establishment, *prior* to the actual federal-provincial negotiations, of a Parliamentary Task Force to examine the fiscal arrangements.

The addition of this Task Force to the process goes a long way towards meeting the problems posed by the criticisms outlined. Through the creation of the Task Force, there was for the first time in history a forum for parliamentary discussion in advance of the hard negotiations with the provinces. At the same time, the Task Force was given a mandate to travel across the country and hear a broad spectrum of opinions on the topic. This meant that the Task Force was not just a means of parliamentary discussion but also a forum for groups and individuals previously excluded to a large extent from intergovernmental negotiations. Accountability was also enhanced by the submission of the Minister of Finance to the Task Force in advance of the negotiations. Some provinces also brought forth their views in the same forum. The

Task Force, therefore, has helped to strengthen the degree of accountability between the executives of government and Parliament, as well as between those executives and the public in general.

In order to pass final judgment on the appropriateness of these criticisms with respect to the fiscal arrangements, there are a number of general qualifications that need be raised concerning the democratic nature of the process. It should be pointed out that secrecy is a characteristic often attributed to modern governments generally; thus it cannot be said to be just a *feature* of intergovernmental relations. The resolution of secrecy problems may entail the introduction of freedom-of-information legislation and other measures designed to reduce the general level of secrecy in government. Furthermore, it is not clear that the process of negotiating federal-provincial fiscal arrangements is solely responsible for the "low levels of citizen participation." The issues associated with the fiscal arrangements are difficult, complex, and highly technical in character. This does not make it easy for most citizens to understand how they might be affected by these issues. Moreover, the question of accountability is one raised frequently with respect to modern parliamentary government in general; hence it involves far more than federal-provincial relationships. The development of the modern-day party system and the growth in the powers of Cabinet during this century have made difficult the delineation of clear and straightforward lines of responsibility in the political system.

This leads to an important consideration that should not be overlooked. The nature of modern-day parliamentary democracy is such that executive decision making is the norm, not the exception. It is, after all, members of the Cabinet and the Prime Minister to whom the electorate gives the responsibility for decision making, subject to the approval of Parliament. Consequently, while the intergovernmental review of the fiscal arrangements involves executives from several governments, the fact that these executives are responsible for decision making is by no means an uncommon trait in the parliamentary system.[17]

A major issue raised by executive federalism in this regard is the extent to which parliamentary democracy is, or should be, adaptable to the model of decision making in the U.S. federal system. In the U.S. system, there is not such a "monopoly" on decision making at the executive level. The doctrine of separation of powers gives Congress a greater opportunity to initiate policy and to modify policies proposed by the Administration, subject to the veto power of the President, than is the case with Parliament in Canada. If the assumption is made that Canada's parliamentary system should move in the direction of this model, the charges of a lack of openness and participation in intergovernmental affairs become much more serious.

The level of openness, participation, and accountability that is appropriate can, in all fairness, only be judged in comparison with other similar processes in Canada's parliamentary system. Perhaps the most important characteristic of the review of the fiscal arrangements in this sense is that the programs concerned are the responsibility of the federal Department of Finance. It should therefore be stressed that, more often than not, most financial legislation is subject, for quite legitimate reasons, to secrecy and confidentiality. The preparation of the budget is the most obvious example.

In seeking candidates for comparison among financial legislation, the Bank Act stands out as the process most similar to the review of the fiscal arrangements. The Bank Act, like the fiscal arrangements, undergoes a broad review on a regular basis, although it occurs at ten-year, as opposed to five-year, intervals.

Using the Bank Act as a benchmark upon which to judge the democratic character of the fiscal arrangement reviews reveals some important points. First, the practice of reviewing financial legislation regularly, as in the case of the Bank Act or the fiscal arrangements, is a democratic feature. Any other statute is only open to review subject to the discretionary initiatives of the executive. Indeed, some have argued that this type of feature, sometimes referred to as a "sunset clause," should be more widely used.[18]

Second, the Bank Act is subject to considerable scrutiny and review by House of Commons and Senate Committees, in draft form, prior to the introduction of the government's "final" version of the legislation. This gives interested groups and Members of Parliament ample opportunity to make recommendations on amendments *before* the executive determines its final version. In contrast, except for the current round of negotiations with the Parliamentary Task Force, there has rarely been any such opportunity for input by Members of Parliament and by interested groups to changes in the fiscal arrangements legislation. Until now, proposed amendments only went to Parliament after the executives of the different governments had reached agreement. As a result, the federal government was usually reluctant to accept major changes to the legislation as it went through the various stages in Parliament. Passage of the legislation through Parliament amounted to little more than an explanation of the terms agreed to with the provinces.

On balance, then, the general criticism that intergovernmental affairs are not sufficiently democratic seems valid in terms of the level of openness and participation in the process. This process does not allow for as much openness as it might, in the sense that it does not provide sufficient opportunity for parliamentarians and affected groups to make known their views and recommendations prior to negotiations among governments.

While the democratic character of the negotiations on the fiscal arrangements seems legitimately in question, it is more difficult to assess the criticisms of executive federalism as they relate to the effectiveness of policy making in the fiscal arrangements. This evaluation depends to a considerable degree on judgments about the extent to which goals have been achieved in practice.[19] Two questions are raised in considering Professor Smiley's critique: Have the reviews adequately dealt with all the issues and views of concerned groups? Has the process been successful in reconciling federal-provincial conflict?

It is argued, in connection with the first question, that intergovernmental affairs in Canada significantly influence the nature and definition of the issues to be discussed and resolved by governments. Professor Smiley contends that intergovernmental affairs permit the regional and territorial dimensions of the issues to be overemphasized. By casting regional representatives in central roles and by excluding from negotiations affected groups that have special interests (most often defined by their needs and role rather than territory), he argues that intergovernmental relations in Canada minimize and undermine ways of thinking about policy making.[20]

When considering this argument in terms of the reviews of the fiscal arrangements, it is by no means clear that these reviews have led to overemphasis on regional concerns. There is implicit in this argument a rather significant assumption – namely, that the regional dimensions of the issues could be much less relevant for the political system. In most federal states, regional issues are strong no matter what the institutional framework, although the regions need not be identical to those currently in Canada. Moreover, while it is true that groups with specific needs and interests have been excluded from the actual negotiations, it is difficult to identify issues in the fiscal arrangements that arise mainly because of regional concerns. For example, one might suggest that provincial objections to the use of the federal spending power in areas traditionally thought to be under the jurisdiction of the provinces is an instance of a "regional" bias; one could argue just as easily, however, that the provinces' position on this matter is based on their belief that a provincial government is in a better position to deliver services to citizens. Taking everything into account, then, it is fair to say that the issues involved in the reviews are directly related to the goals of achieving efficiency and equity in government finance and in social services throughout the nation. The importance of these national goals does not seem to be outweighed by regional concerns in the fiscal arrangements.

Another argument made by Professor Smiley is that intergovernmental affairs reinforce the specific interests of those involved in the process. This general critique would seem valid when applied to the reviews of the fiscal arrangements. Some have cited the treatment of social policy in the fiscal arrangements as an example that proves the argument. It has been suggested that since the central participants from the Ministries of Finance focus primarily on the distribution and sharing of revenues and on their links with tax and economic policy, the review tends to ignore important issues of social policy that may also be at stake.[21] Beginning with postsecondary education in 1967 and followed by health and hospital care in 1977, it is said that these major areas of social policy have come to be cast primarily as fiscal problems. One participant in 1967 underlined the extent to which certain policies are excluded from the negotiations when he observed: "The ministries of education ... were virtually silent partners.... Educational policy was not only confined to the bleachers; in fact it failed to secure entry into the stadium."[22]

Another example of the extent to which the specific interests of the participants from the Ministries of Finance limit the review of issues was suggested in the preceding chapter dealing with tax harmonization. The crucial problems relating to tax harmonization, it was argued, are not distinct from those created by other "non-tax" economic policies followed by governments – for example, discriminatory expenditures and regulations – that are also aimed at promoting growth and investment. The considerable emphasis on the need for tax harmonization that characterized previous reviews of the fiscal arrangements can be partly explained by the responsibilities of the Ministries of Finance. While they are clearly accountable for tax policy, other departments such as the federal Department of Industry, Trade and Commerce and its provincial counterparts have the lion's share of responsibilities for the other type of economic programs so important to economic stabilization and harmonization.

From these examples it is evident that there is some truth to the suggestion that the participants in the process tend to have a narrow focus, sometimes overlooking broader policy issues. This point should

not be taken too seriously, however. To the extent that the priority of the participants in the negotiations is to reach compromise and agreement, it is mandatory that there be some focus and some limit to the discussion.

The two examples from the review of the fiscal arrangements, cited above, demonstrate how this is so. In the case of social programs, what is really being asked is that discussion between federal and provincial authorities focus more sharply on policy issues in areas that have traditionally fallen primarily under provincial jurisdiction, especially postsecondary education. There has been understandable reluctance on the part of both levels of government to discuss issues in these areas too closely in order to avoid jurisdictional conflict. Similarly, in considering the narrow focus of those involved in developing tax harmonization, one cannot overlook the considerable extent to which the question of taxation has been a central cause of *conflict* between the provinces and the federal government throughout the history of the negotiations.

Professor Smiley's other two major criticisms concerning the effectiveness of decision making in intergovernmental affairs are related. The validity of his suggestion that executive federalism encourages the "indiscriminate" growth of governments presupposes that intergovernmental affairs in Canada are marked by a high degree of conflict. If one assumes otherwise – that intergovernmental relations have led to a high degree of compromise – it is very difficult to argue that the machinery of intergovernmental liaison is without purpose. Consequently, the growth of governments in general and of the committees associated with the reviews of the fiscal arrangements cannot easily be termed "indiscriminate."

In considering these criticisms in terms of the fiscal arrangements, the history of the negotiations to date tends to support the assumption that there has been a high degree of compromise and a rational development of intergovernmental relations. It would be misleading to suggest that there has not been conflict involved in the fiscal arrangements or that the programs themselves have not been without difficulties. Indeed, the problems with the programs are the subject of this report. Nevertheless, it seems correct to say that, by and large, the process of negotiating federal-provincial fiscal arrangements *has* led to agreement on reasonably successful policies. In substantive terms, a fairly uniform system of taxation has been established that provides for much provincial flexibility. A sophisticated system of equalization has been put in place that goes a long way towards achieving its underlying goals, while relatively high and uniform standards have been established with respect to the major social programs. All of this has been accomplished despite recurring intergovernmental conflict.

The high degree of compromise in the negotiations to date may in fact be explained by the relatively restricted focus of the participants. By concentrating on questions related to the sharing of revenues and to the links between tax and economic policy, the negotiations on the fiscal arrangements have effectively limited the potential areas of conflict. This focus may also explain why in these intergovernmental negotiations, unlike in others, it has proved possible to reconcile differences. As intergovernmental negotiations broaden in context, it appears that agreement becomes more difficult to attain.

From this broad perspective of the reviews of the fiscal arrangements, the growth of intergovernmental committees to deal with the negotiations on the fiscal arrangements poses less of a problem than has been suggested. There is little doubt that the processes in the reviews demonstrate the growth of modern-day governments. Yet there may be good reason for the complex forms of consultation and co-operation in these arrangements; they are required to make the intergovernmental programs work and to enable compromise among governments.

Federalism and Interdependence

Another set of general criticisms raised recently about intergovernmental affairs in Canada relates to the nature of federalism. At issue is the appropriate role for each level of government, as well as the proper balance of power between the different levels of government in the federal state. A fundamental aspect of these problems concerns the nature and degree of intergovernmental co-operation between governments.

Since the reviews of the fiscal arrangements depend on effective co-operation between governments, these general criticisms relate directly to the arrangements. The direct links between these general problems and the fiscal arrangements are demonstrated by the current negotiations. In April 1981, the federal Finance Minister argued before the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements that the fiscal strength of the provinces as a whole had resulted in considerable political leverage for the provinces and in less political strength for the federal government.[23] By suggesting that a "fiscal imbalance" was associated with a "political imbalance" the Finance Minister was arguing, in effect, that the current roles of each level of government are inappropriate and that a better balance of power should be sought.

The Economic Council of Canada does not feel it appropriate to make judgments on the state of federalism in Canada today. Such judgments involve broad political choices that are beyond the scope of the report and of the Council's responsibilities. Nevertheless, the Council believes it is necessary to raise these issues in relation to the fiscal arrangements, especially since the Finance Minister did so himself.

The problems for the Canadian federal state that are perceived to be created by intergovernmental relations depend very much on the particular model of federalism that is considered to be ideal. Professor Alan Cairns of the University of British Columbia has identified two models that underline the different conceptions of federalism.[24] The first, termed "interstate" federalism, is usually considered to be that which guided the Fathers of Confederation. That model provides for a clear delineation of powers between the federal and provincial governments. Apart from the enumerated areas of jurisdiction, the federal government is accorded the residual power and overriding authority in situations of national emergency involving "peace, order and good government." In this model, the key institutions at the centre do not just reflect regional interests, but also interests of a broader, national character. In the case of interstate federalism, the federal government has the primary responsibility for ensuring uniformity in the nation and in interregional linkages, as well as for conducting international relations.

The second model, termed "intrastate" federalism, emphasizes the need for a strong role for regional interests in national policy making. The political institutions at the centre, therefore, are required to place high priority on policy compromises among the representatives of competing regional interests. Inherent in "intrastate" federalism are two basic options. The *centralist*, or *nationalist*, option seeks to make the central government more responsive to regional diversities by minimizing the role of provincial governments and by expanding the importance of regional representation in national institutions such as Parliament and the Supreme Court of Canada. The opposing *provincialist* option provides for enhancing the power and influence of regional or provincial governments as the main proponents of territorial interests.

In the case of the "interstate" model of federalism, the development of a high level of intergovernmental co-operation and interdependence is deemed necessary because the division of powers between the two orders of government has become inappropriate in modern-day circumstances. It is argued that in these circumstances the effective division of powers has become looser than originally intended, with the result that the interests and activities of the two levels of government overlap in almost every field of policy. On the basis of this model, it is argued that serious problems often emerge in this interdependent environment because there is no one level of government that, practically speaking, is supreme in any area, and there is no effective means of resolving conflicts between governments.[25] Proposals for reform, thus, aim to restructure the division of powers,and to settle the question of supremacy in the various jurisdictions.

Problems created by intergovernmental relations under the "intrastate" model of federalism vary considerably, depending on whether the nationalist or provincialist version is favoured. The arguments in favour of national institutions having strong regional representation often appear to develop in circumstances where conflicts involving provincial or state governments have grown to an unacceptable level. Indeed, some of the proposals for strengthening regional interests in national institutions put forward over the past few years by the federal government and others imply that such a condition has already been reached. This situation is thought to have developed in part for the very reason that the central government has failed to take adequate account of regional interests in the development of its own policies. Proposals for reform, therefore, often envisage increased representation of regional interests at the national level. Among other things, this would require a loosening of party discipline and of the doctrine of ministerial accountability to Cabinet in order to allow for more vigorous and open regional representation. In addition, there has been a series of reforms proposed with respect to such national institutions as the Supreme Court and the Senate in order to strengthen the representation of regional interests in the central government.

In the case of the provincialist intrastate version of federalism, the primacy of government-to-government relations is not questioned. The approach to reform proposed by adherents of this school of thought involves the establishment of more-formal institutions for the conduct of intergovernmental affairs so as to enable the provinces to speak with a strong voice. Proposals for reform vary as to degree, ranging from a minor adjustment of the current processes to the establishment, through constitutional amendment, of an entirely new level of government to make decisions on matters involving intergovernmental affairs. These latter proposals often suggest transformation of the Senate into a National Council. While representatives of federal and provincial governments might be members, such a Council would, in effect, become a third level of government

armed with constitutional authority to determine policy involving federal-provincial arrangements. It would, in fact, be superior to both the federal and the provincial governments in matters involving the two levels.[26]

The general views of intergovernmental affairs based on the different models of federalism are relevant to the fiscal arrangements. For example, following the provincialist intrastate approach, some have argued that the Parliamentary Task Force was only a means of reinforcing the centralist posture of the federal government. The argument is that the federal Task Force could be used to downgrade the provinces to a position where they would be just another interest group pressing a case with the national government. Under these circumstances, the demands of the provinces could be given the same treatment by the federal government as those of any other witnesses before the Task Force.[27] Some have also argued, in line with the intrastate approach, that processes like the reviews of the fiscal arrangements should have more formalized committees and decision-making procedures. Often those who favour greater formalization of federal-provincial bodies recommend the establishment of an advisory secretariat, or commission, on economic matters that would be composed of officials independent of the federal and provincial governments.[28]

The Economic Council does not consider it appropriate to make recommendations on the broad issues raised by these approaches to federalism and their application to the fiscal arrangements. Still, the analysis and character of the review do provide a basis for comment relevant to the debate.

Perhaps the most important lesson to be learned from the reviews of the fiscal arrangements is the extent to which governments in Canada are interdependent. Activity and responsibility in many areas of public policy are shared. In few fields does one government act alone; many activities by each level of government are interconnected.

The degree of interdependence inherent in the fiscal arrangements and their review leads to another important lesson. In light of these arrangements, it would seem inappropriate to attempt to recompartmentalize forever the roles of each level of government. The formal powers of government may be defined initially by a constitution, but thereafter the political and legal process actively defines the powers to be held by the governments in response to continuing economic and social changes. Professor W. R. Lederman of Queen's University has put this point well:

> . . . federal and provincial categories of power are expressed, and indeed have to be expressed, in quite general terms. This permits considerable flexibility in constitutional interpretation, but it also brings much overlapping and potential conflict between the various definitions of powers and responsibilities. To put the same point in another way, our community life – social, economic, political and cultural – is very complex and will not fit into any scheme of categories or classes without considerable overlap and ambiguity occurring.[29]

With respect to the question of striking a "proper balance" between different orders of government, as raised by the federal Finance Minister, the lesson gleaned from experience with the fiscal arrangements appears to be that this is always an issue in a federal state. This is a point often missed by those who stress the current need for a substantial revision of the Constitution to redefine the formal division of powers between governments. In the federal state, a degree of interdependence and co-operation is necessary to ensure that one level of government does not dominate the other and thereby reduce the nation to one unitary state or a series of unitary states operating within the geographic framework of a single country.

Professor M.J.C. Vile of the University of Kent has provided a useful definition of federalism that depicts this well:

> Federalism is a system of government in which central and regional authorities are linked in a mutually interdependent political relationship; in this system a balance is maintained such that neither level of government becomes dominant to the extent that it can dictate the decisions of the other, but each can influence, bargain with, and persuade the other. Usually, but not necessarily, this system will be related to a constitutional structure establishing an independent legal existence for both central and regional governments, and providing that neither shall be legally subordinate to the other. The functions of government will be distributed between these levels (exclusively, competitively, or co-operatively), initially perhaps by a constitutional document, but thereafter by a political process, involving where appropriate the judiciary; *in this process the political interdependence of the two levels of government is of the first importance in order to prevent one level absorbing all effective decision-making power* [Emphasis added].[30]

In such a federal state there may always be the question of how to ensure the maintenance of "proper balance" between the two powerful orders of government. While achieving and maintaining such a balance does create difficulties, this ever-present conflict does have its positive aspects. After all, it is a sign that "federalism" is truly functioning in a dynamic way within the state.

Conclusions

In examining the politics and the process involved in reviewing the fiscal arrangements every five years, one major set of problems was identified. These problems concerned the democratic character of the review in the sense of its level of openness and participation.

To a considerable extent, the various committees established for the negotiation of the fiscal arrangements meet behind closed doors. Traditionally, information has not always been made available in advance to legislative members or the public at large about the issues under negotiation; to a far less degree has the opportunity been provided for parliamentarians and affected groups to express their views on the matters in question despite the fact that their interests may be vitally affected by the outcome. Furthermore, more information could be made available on the actual work done to arrive at the agreement on the fiscal arrangements through this process of closed negotiations, and more opportunity could be provided for legislative bodies and the public to review and comment on the resulting effects of such arrangements.

Looking to the future and possible reforms, the establishment of the federal Parliamentary Task Force prior to the current negotiations on the fiscal arrangements seems like a model worth following in coming reviews. On the face of it, it appears that the addition of this Task Force goes a long way towards making the process more open to Parliament and to groups deeply concerned with the fiscal arrangements.

Despite the attractiveness of many features of the Task Force, a certain number of outstanding questions remain concerning it. For example, while the value of the Task Force as a forum for airing the views of parliamentarians, and groups should not be overlooked, it is unclear to what extent its recommendations will contribute to the actual negotiations between the two levels of government. If the recommendations are largely ignored, the contribution of the Task Force to an open process will be less significant, at least in the short term. Moreover, as outlined earlier, some view the Task Force as merely another means of reinforcing the centralist posture of the federal government.

Although our analysis shows room for more openness and participation in the process, this does not mean that such changes are without dangers and disadvantages. On the contrary, in comparing the review of the fiscal arrangements with other intergovernmental processes, it was noted that meetings of the First Ministers, which have been subject recently to more openness, have not always led to as high a degree of compromise as has characterized the fiscal arrangements. In addition, it was suggested that one factor that has contributed to the reconciliation of conflicting positions during the negotiations is their limited focus; as intergovernmental negotiations broaden in scope, it appears that agreement becomes more difficult to attain.

Nevertheless, the potential disadvantages and dangers in increasing the openness of the process of review are, in our view, outweighed by the advantages. The type of process the Council would like to see established to deal with the fiscal arrangements is one similar to the decennial review of the Bank Act – a process that is marked by a high degree of openness and participation. Using the Bank Act as a benchmark for comparison, making the review of the fiscal arrangements more open is an option that seems both practicable and attractive.

Despite the appropriateness of the analogy with the Bank Act, there is one sense in which it is not applicable to the fiscal arrangements. This has to do with what, in our view, should be an important characteristic of this "open" process. Revision of the Bank Act is solely a federal matter, with the provinces basically being in a position very similar to that of any other interest group. While formally the fiscal arrangements between the two levels of government may be a federal matter, in practice the provinces are actively involved in the review of these arrangements, having real bargaining powers. It should be stressed that the need for greater openness and participation in the review of the fiscal arrangements is a matter relevant not just to Parliament, but also to provincial legislative assemblies.

The value of increasing openness and participation in the review of the fiscal arrangements, especially for the future, should not be underrated. Broadening the democratic character of the process seems a necessary step in the complex and interdependent world of governments. Moreover, greater participation and openness in the review are significant for the nature of the programs themselves. A more open and all-encompassing review will bring to bear the views of parliamentarians and affected groups on executive federalism. As such, the review will be even more consistent with the principles behind parliamentary government and federalism in Canada.

11 The Issues: Conclusions and Recommendations

The Need for Change in the Fiscal Arrangements Act

An argument could be made for little change in the 1982 Fiscal Arrangements Act in order to minimize federal-provincial tension. The renewal of the legislation follows a period of considerable friction in federal-provincial relations generated by controversy over major constitutional and energy issues. It might also be argued that because far-reaching reforms were made only in 1977, further radical change is inappropriate at this time.

In contrast to these arguments, it can be contended that further change is inevitable because of the dissatisfaction of both levels of government with the current fiscal arrangements. Thus, it may be claimed, the major change in the 1977 Fiscal Arrangements Act – the replacement of shared-cost programs in health and higher education by block funding in the Established Programs Financing arrangements – has only led to further controversy. Because of its evident dissatisfaction with the operation of the new block-funding scheme, the federal government appointed a Royal Commission on Health Services (chaired by the Honourable Emmett Hall) to examine its effects on the provision of health care.[1] As part of its overall strategy to reduce its budgetary deficit and shift its spending priorities towards economic development, the federal government has indicated that it wants to achieve significant savings in transfer payments to provincial governments, most of which are part of its "social affairs" budgetary envelope. The federal government has also instituted major changes in the Equalization Program since 1977 in an effort to limit its outlays. Provincial dissatisfaction with some aspects of the fiscal arrangements is also indicated by the withdrawal of Alberta – and the threatened withdrawal of British Columbia – from the Tax Collection Agreements.

The Council is of the opinion that basic changes in the Fiscal Arrangements Act cannot, and should not, be postponed indefinitely. We have had as our objective the search for long-term principles to govern these arrangements that are equitable to all parties concerned, that contribute to stability, and that are durable in the face of rapid economic change. In some instances, the Council feels that these principles can be implemented in the forthcoming legislation. In other cases, the Council recognizes that further information and analysis is required before its proposals can be fully assessed. Adoption of these proposals would also require a wide degree of public and governmental support, which can only be achieved by extensive and thorough public examination and discussion. The Council urges that the federal and provincial governments accord high priority to examination of these longer-run proposals.

The Council's analysis has focused on six aspects of federal-provincial fiscal relations. We have examined the question of whether there is evidence of "fiscal imbalance" between the two levels of government that requires reductions in federal transfers to the provinces. We have also examined questions concerning the future of the Equalization Program, Established Programs Financing, and of federal-provincial transfers in the areas of health and post-secondary education. Another subset of questions concerns the future of arrangements dealing with fiscal co-ordination between the federal and provincial governments in such areas as taxation and stabilization policies. Finally, the Council has examined questions relating to openness and accountability in the process of negotiating the fiscal arrangements. Our recommendations concerning each of these areas follow in succeeding sections of this chapter.

Fiscal Imbalance and Proposals for Reductions in Federal-Provincial Transfers

For the first time in the history of the fiscal arrangements legislation, as indicated in Chapter 1, the federal government is approaching negotiations with the provinces with the intention of reducing the amount of transfers. Specifically, the federal Minister of Finance indicated in his Budget of October 1980

that his goal was to achieve savings in federal transfers to the provinces of around $1.5 billion in 1982/83 and 1983/84. Subsequent statements by federal government spokesmen have indicated that much of that reduction is expected to come from transfers to the provinces for social programs.

Two reasons have been advanced for the federal proposal to reduce federal-provincial transfers for social affairs. In the first place, the Minister of Finance has stated that "the most urgent priority of the federal government is to strengthen its fiscal position," adding that "transfers to the provinces cannot be insulated from policies of restraint." In support of this position, the Minister has also argued that there exists an "intergovernmental fiscal imbalance" in Canada at present, which he defined as "the fact that one order of government has a large and persistent deficit or surplus in its accounts in relation to that of another order of government."[2]

This reasoning, if accepted, would support general cuts in federal-provincial transfers. It does not support reductions in transfers for social programs in particular. The October 1980 Budget indicated, however, that the federal government wished to reallocate its spending from social affairs to economic development.

The Council has considered these rationales for reductions in federal-provincial transfers in general and for transfers for social programs in particular. The argument that there is a fiscal imbalance in the Canadian federal system might have merit if, for instance, it could be shown that there was a structural obstacle in our federation that barred access by federal or provincial governments to the revenues needed to fulfill their constitutional responsibilities. Since both federal and provincial governments in fact have access to all major revenue sources, the Council sees no evidence that such a structural imbalance exists in our federal system. The mere existence of deficits at one level of government does not indicate the existence of such a structural imbalance nor does it mean that such deficits have to be rectified at the expense of another level of government.

This is not to say that the federal deficit has been of no concern to the Council. We have found no meaningful evidence, however, that would link increases in the federal deficit between 1975 and 1980 to federal-provincial transfers. Perhaps most importantly, the Council finds that with the acquisition of new revenue sources as a result of the recent federal-provincial agreements on energy pricing, the budgetary outlook of the federal government has substantially improved.

The Council also notes that the effects of reductions in federal transfers to provincial governments have to be considered for *both* levels of government. The fact is that of ten provincial governments, all but the three resource-rich western provinces have been incurring budgetary deficits in recent years, despite several years of general restraint in the growth of provincial expenditures. As noted in Chapter 1, federal-provincial transfers constitute a large proportion of the revenues of many of these provincial governments. Strictly from a budgetary point of view, therefore, the Council sees little merit in reductions in federal-provincial transfers that would, in effect, merely shift part of the burden of a declining federal deficit to less fortunate provincial governments.

As noted above, the proposed reduction in transfers to provincial governments for social programs also indicates a change in the priorities of the federal government. This proposal may reflect a conviction on the part of the federal government that it has been paying more than its "fair share" of expenditures in the areas of health and higher education – a conviction that may have been reinforced by the outcome of the 1977 negotiations relating to the Revenue Guarantee. As a result of these negotiations, the federal government transferred to the provinces through the EPF program the equivalent of two personal income tax points in order to reach compromise on the termination of the Revenue Guarantee Program then in place, a concession that some observers viewed as giving the provinces an undeserved bonus.

One of the major problems that has arisen with respect to the transfer of funds to the provinces by the federal government under the EPF programs concerns the lack of accountability as to the efficiency and effectiveness of these expenditures. Because an improved system of accountability could better assure the achievement of federal objectives, we intend to focus some attention on means of resolving this problem.

The Council is clearly not in a position to express judgment about the overall priorities of the federal government, as reflected in the 1980 Budget. At the same time, however, we do not consider that a reduction in EPF transfers is consistent with either the resolution of the financing problems currently existing in the fields of health and postsecondary education or the attainment of the federal government's stated objectives with respect to these sectors.

Accordingly,

1 We recommend that the federal government reconsider its proposed reduction in transfers to the provinces.

The Equalization Program

The program of federal equalization payments to "have-not" provinces is one of the major vehicles of intergovernmental redistribution in Canada. Its importance to the nation is shown by the agreement among all governments to give it formal status in a patriated Constitution. A significant part of the Council's work has involved an examination of the past and future of the program, which is due to expire in 1982.

The program has run into significant difficulties in recent years. A previously stated objective of this program – to raise the revenue capacities of all provincial governments to the average for all Canadian provinces – has not proved to be sustainable. This has been a consequence of the increase in natural resource revenues that has accrued to western provincial governments since 1973. These increases in revenues did not accrue to the same extent to the federal government, which was nevertheless forced as a consequence to make large disbursements in equalization payments to the "have-not" provinces out of its general revenues. The resulting pressure on its budget led the federal government to impose a number of *ad hoc* limitations on the extent to which resource revenues enter the equalization formula and the extent to which provinces are eligible to receive payments.

These restrictions have had some unfortunate effects in terms of equity. The most notable of these effects has been on Ontario. Federal taxpayers in this province contribute substantially to the financing of the Equalization Program. But Ontario was made ineligible to receive equalization payments by a change in the rules of the program that disqualified provinces in which personal per capita income was above the national average in the current and two preceding years. The result is that the net effect of the Equalization Program is to reduce Ontario's revenue capacity to well below that of the national average.

At first glance, it appears as though the resource-rich provinces escape lightly in contributing to the financing of the Equalization Program. This, however, is only part of the picture. Council research indicates that the amount of redistribution that takes place as a result of inclusion of natural resources in the Equalization Program is dwarfed by the amount of redistribution that has been taking place through other mechanisms. For example, an estimated $13 billion of natural resource rents were redistributed from Alberta to the rest of Canada in 1980 mainly as a result of the federal government's policy of maintaining the domestic price of oil and gas well below world levels. This implicit transfer exceeded *all* cash transfers from the federal to provincial governments in 1980/81. It is obvious, therefore, that the treatment of natural resource revenues in equalization cannot be considered in isolation from the more general issues of the sharing of resource revenues and jurisdictional rights to these resources.

The Search for Principles Governing Equalization

The treatment of natural resource revenues may be one of the most difficult issues that must be faced with respect to equalization in future; it is the view of the Council, however, that it may not be the most *fundamental* issue. A more pressing concern may be the determination of principles on which a sound and durable equalization program can be based.

The *ad hoc* changes made during the lifetime of the present program have called into question the principles on which the program was originally based. Moreover, substantial opposition to the concept of equalization has also developed among some economists in recent years. It can be argued that the present system of intergovernmental transfers (including equalization) and governmental transfers to persons conflicts with the goal of national economic efficiency. It has been contended that this transfer system has led to an unhealthy dominance of government expenditures in the economies of the "have-not" provinces, with some of the latter being reduced, in effect, to a state of dependency. It is also maintained that the transfer system has undermined automatic adjustment mechanisms, such as migration, that would otherwise ameliorate problems of high unemployment and low income in the "have-not" provinces.

The opinions outlined above have become the "conventional wisdom" in some policy-making circles in Canada. They assume even greater importance in view of the present public focus on the problem of slow economic growth and the related need for reallocation of resources in the economy.

For the above reasons, the Council's consideration of the future of the Equalization Program began with a re-examination of the rationale that led to its creation. Through our analysis, it was demonstrated that there *is* an important role to be played by a program of equalization grants in Confederation. The results of this analysis can be briefly outlined.

Although equalization redistributes revenues between governments, our primary concern is the welfare of *people* rather than governments. The criteria governing an equalization program should be aimed at achieving the people-oriented goals of

equity and efficiency, the latter being necessary to increase the standard of living of Canadians generally. The issue of equity arises in relation to the common objectives of governments in Canada to reduce inequalities in real income between individual persons (vertical equity) and to provide similar treatment to people in similar economic circumstances (horizontal equity).

Given these as the generally accepted goals of government policy, the following fundamental question was asked. Why do we need an intergovernmental transfer system when we have in place, at both levels of government, a well-established system of taxes and transfers among persons, households, and firms for regulating the allocation of economic activity and the distribution of its fruits? In other words, what can (or ought to) be accomplished through a system of intergovernmental transfers that could not be accomplished through the tax and transfer system?

The basis of the case for an equalization program lies in the fact that in a federal system such as Canada's, the "market" or taxable incomes of persons do not provide a completely accurate reflection of the real incomes of persons living in different provinces. Provincial government activities give rise to real income differences in the form of net fiscal benefits (defined as the share of public services that a person receives minus the taxes he or she pays) that are not reflected in the personal incomes of individual people. Differences in net fiscal benefits may arise because provinces with high per capita incomes can finance a given amount of public services with less tax effort (lower tax rates on income) than provinces with lower per capita incomes. These differences may also arise because a resource-rich province can use the revenues collected from its natural resources (such as oil rents) to finance public services and at the same time maintain relatively low levels of taxation. The distribution by provincial governments or their agencies of resource revenues in the form of implicit subsidies to users of provincial services (for example, through artificially low electricity prices) constitutes another source of differences in net fiscal benefits that are not reflected in personal incomes.

Since the goals of equity outlined earlier require that governments concern themselves with the *comprehensive* incomes of individual persons, and since the current tax and transfer system is based primarily on personal market incomes, an additional redistributive transfer system that deals with differences in net fiscal benefits from provincial government activities is required to attain equity goals. This purpose can, and should, be served by an equalization program.

There is one important modification to the argument that an equalization program should eliminate *all* differences in provincial net fiscal benefits in order to achieve equity goals. Recognition of the provincial ownership of natural resources granted to the provinces under the BNA Act can be interpreted as conferring certain property rights on the residents of any province over that province's natural resources. The implication of this constitutional provision is that provincial natural resource revenues that are actually distributed to provincial residents should, for reasons of equity, be treated differently in an equalization program. Only a portion of these benefits should be equalized, with the proportion being determined by the tax rate that would apply to these benefits if they were distributed to citizens by provincial governments in the form of personal income and then subsequently made liable to taxation by the federal government.

As noted above, the impact of the Equalization Program on *efficiency* in the allocation of resources has been a matter of controversy. Our analysis of the argument that equalization has resulted in an inefficient allocation of resources in the economy led to the exact opposite conclusion. It was found that an equalization program is *essential* to the efficient functioning of the economy. Economic efficiency requires that factors of production be guided among activities (including those in different provinces when this is an option) by signals related to their productivity in different locations. Differences in net fiscal benefits among provinces tend to distort the market signals that would otherwise be expected to do this job. The only solution to this problem is to eliminate the source of such distortions – that is, the differences in net fiscal benefits arising from provincial government activities.

The empirical research demonstrated that the past effects of equalization and of differences in provincial government financial capacity (arising from natural resource revenues in particular) on the interprovincial migration of labour have been significant enough to justify consideration of the potential efficiency costs of adopting alternative approaches to equalization in the future. It was shown that for low-income persons in particular, these aspects of fiscal structure have been of roughly the same importance as regional differences in employment and income in explaining the recent trends in interprovincial migration. It is evident, therefore, that future increases in the domestic price of oil towards world levels and the resulting increase in the revenue capacity of producing provinces and in the fiscal benefits available to their citizens, particularly if natural resource revenues remain only partially equalized, could have a corresponding impact on the movement of labour. This, in

turn, could create further problems with respect to the achievement of economic efficiency.

The Guiding Principles in Summary

The critical questions with respect to the future of the Equalization Program concern how much in the way of financial resources should be distributed and how. Our analysis provides some answers to these questions after beginning with the assumption that one starts from scratch to develop a fair and effective system of equalization unimpeded by constitutional, political, or other constraints.

Such an equalization program would have as its objective the complete elimination of all differences in the net fiscal benefits received by citizens in different provinces. Put another way, the per capita financial capacity of all provincial governments would be completely equalized. This is the only solution that would be compatible with attainment of equity in the treatment of citizens and efficiency in the allocation of resources in a federal state. There would be no necessity for a federal government to be involved at all in such an equalization program; the redistribution involved would be most simply achieved by direct redistribution between provincial governments.

In actual fact, of course, equalization has long been embedded in Canada's federal-provincial system and has evolved over the years in response to constitutional and political imperatives that cannot be ignored when considering possible program reform.

In the first place, recognition of the ownership of natural resources, granted to the provinces in the Constitution, can, as previously noted, be interpreted as conferring property rights with respect to natural resources on residents of any province. This constitutional provision suggests that there are limits on the extent to which natural resource revenues should be redistributed through equalization. For this reason, the Council has suggested that the amount of resource revenues to be redistributed should be equivalent to the amount that would be paid to the federal Treasury through income tax if natural resource revenues were distributed to residents of a province as income.

The recent constitutional discussions and proposals also have implications for the *mechanics* of the Equalization Program. As indicated, it was universally agreed by all governments participating in these discussions that the equalization concept should be enshrined in a patriated Constitution. Also, there still appears to be widespread agreement that the responsibility for implementing equalization should continue to be assigned to the federal government.

The Financing of the Equalization Program

The guiding principles outlined above present problems for the financing of the Equalization Program. While the distribution of provincial financial capacity for revenue categories other than natural resources generally matches the distribution of federal revenue sources, this has not been the case for natural resource revenues. In fact, until the recent agreement was reached on petroleum pricing and revenue allocation, it was difficult to reconcile constitutional assignment of property rights over natural resources to provinces and federal responsibility for a program that equalizes access to these resource revenues. The Council is of the view, however, that this problem, which has plagued the financing of the Equalization Program for some years, has been greatly reduced with the conclusion of the energy pricing agreements between the federal government and the oil- and gas-producing provinces.

This is not to say that all questions related to the financing of equalization payments arising from natural resource revenues or rents have been settled for all time. The problem of financing equalization payments is accentuated when there are sharp increases in the value of a resource that is unevenly distributed across the country. The large increases that have taken place in energy prices since 1973 have highlighted this problem. While oil and gas rents are currently of a size that dwarfs all other rents collected or distributed by governments, it is entirely possible that the role of oil and gas rents in our recent history will be replaced in future by rents arising from other resources.

The Determination of Equalization Payments

Provincial Non-Resource Revenues

The Council sees no major problems with the mechanics of the present Equalization Program insofar as its treatment of revenues other than natural resource revenues is concerned. Although a number of changes to the "ideal" program are involved, the Council does not believe that they are of overwhelming significance.

The only modification to this part of the program that the Council would propose concerns the role of local government revenues from property taxes. Part of these revenues (those related to school taxes) are already included in the equalization formula. The Council considers that there are good reasons for including all local government revenues from property taxes. As noted above, we view the objective of the

Equalization Program as being to reduce the interprovincial differences in net fiscal benefits between persons that arise from regional government activities; it makes no difference whether these net fiscal benefits arise because of provincial government activities or local government activities.

Therefore,

2 We recommend that all local government property taxes be included in the equalization formula.

Resource Revenues

A considerable amount of Council analysis has been devoted to the problem of developing equitable, uniform, and durable principles to govern that part of the equalization formula relating to resource revenues. It should be reiterated that this is the aspect of the present equalization formula that is most arbitrary. At present, equalization of resource revenues is limited to one-third of the total equalization payments. Within the resource revenue category, moreover, different types of revenues receive totally different types of treatment: some revenues are equalized in full (e.g. renewable natural resource revenues, such as forestry revenues); only half of other revenues are equalized (revenues arising from non-renewable resources); and some resource revenues that are collected by provincial governments are no longer equalized at all (revenues from the sale of Crown leases).

In addition to the provincial natural resource revenues that are taken into account for equalization purposes, as outlined above, the provinces also have available to them large economic rents from certain natural resources that are not collected but, instead, are passed on to consumers in the form of subsidized prices. These forgone revenues, however, are not included at all in the equalization formula. The Council considers there to be a need to determine the magnitude of rents being passed on to consumers in this way. While the case of hydro-electricity is the most obvious example, it is undoubtedly not the only one.

Based on our analysis, we have concluded that in the longer term the following principles should apply with respect to inclusion of resource revenues in the equalization formula:

- ***all natural resource revenues distributed by provincial governments to residents of a province should be taken into account in the equalization formula. It is immaterial whether this distribution takes place directly in the form of goods and services and/or tax relief, or indirectly in the form of subsidized prices;***
- ***resource revenues should be equalized when they are distributed as income to residents of the provinces. Thus funds deposited in heritage, or other savings, funds should not be equalized; they should only be subject to equalization when they commence to provide benefits to provincial residents;***
- ***the amount of provincial natural resource revenues that is subject to equalization should approximate the federal taxes that would be paid, on average, if resource revenues were distributed to provincial residents and treated as personal income;***
- ***there should be no artificial limits, as at present, on the extent to which eligible natural resource revenues are equalized.***

It is of considerable importance to outline the likely financial effects of applying these principles to the treatment of natural resource revenues in the equalization formula. These effects may best be assessed in relation to those of our other proposals with respect to the Equalization Program. The latter would have the result of increasing *total* outlays on equalization and would not significantly decrease the equalization payments currently going to any individual provincial government. By way of contrast, incorporation of the principles with respect to the treatment of natural resource revenues would not only lower the total outlays on equalization in real terms over the long run but would also redistribute the payments significantly.

Preliminary econometric simulations of the proposed changes indicate that if they were implemented immediately the amount of equalization payments resulting from natural resource revenues would be substantially reduced. But if these changes were introduced some years down the road, when domestic oil and gas prices and thus the revenues of producing provinces will be considerably higher, the amount of equalization payments resulting from resource revenues would be only moderately lower than they would be under the present formula.

The proposed treatment of natural resource rents which are presently distributed in the form of price subsidies to consumers would also significantly alter the distribution of equalization payments among provinces. This reflects the fact that natural resource benefits are more evenly distributed across the nation than appears to be the case when account is taken not only of resource revenues collected by the provinces through taxation but also of uncollected economic rents passed on to consumers through subsidized prices.

In submitting these proposals, the Council is under no illusions as to their immediate acceptability or applicability. Indeed, it would be presumptuous to assume otherwise, especially since the reduction of equalization payments that would result from a system based on these principles might seriously affect the fiscal capacity of the poorest provinces. Our primary goal is to provoke further public examination and discussion.

We also believe that fundamental changes in the treatment of resource revenues under the Equalization Program should not be put off indefinitely. Further *ad hoc* changes will undoubtedly take place in the absence of any decision on the fundamental principles that should guide this part of the program; the present inequities in this part of the program will continue. The Council is concerned, however, that any *interim* arrangements with respect to the treatment of natural resource revenues in the equalization formula should not impede movement towards a program based on more enduring principles.

Until such a program emerges, the Council believes that it would not be appropriate, or desirable, for equalization payments to increase substantially from their current levels, in real terms, on account of natural resource revenues. Some form of constraint should therefore be placed on the payments arising from the equalization of these revenues in the interim. At the same time, however, the Council does not think that it would be desirable, or appropriate, for equalization payments arising from natural resource revenues to be reduced significantly in real terms pending the adoption of longer-term arrangements.

Accordingly,

3 We recommend that, until more permanent arrangements can be established, total equalization entitlements arising from natural resource revenues for all the provinces having positive resource revenue entitlements should be constrained. The constraint applied to annual growth, beyond the level for 1981/82, should be determined either by the yearly rate of growth in equalization payments arising from non-resource revenues or by the annual rate of growth in national economic activity, as measured by an indicator such as gross national product.

Given the above constraint on the growth of positive equalization entitlements arising from natural resource revenues, the Council considers it important that the distribution of entitlements to equalization be determined as equitably as possible under present circumstances. More particularly, it believes that there is little justification for calculating entitlements for renewable and non-renewable resources on a different basis and for excluding revenues from the sale of Crown leases in the calculation of entitlements.

Therefore,

4 We recommend that, in determining entitlements before applying the constraint previously proposed, all revenues from non-renewable resources and from the sale of Crown leases be included for equalization purposes.

The Council has one final recommendation with respect to the Equalization Program that it considers should be implemented immediately. The provisions of the Equalization Program should not treat Ontario or any other province in an arbitrary and anomalous fashion.

Therefore,

5 We recommend that any special provisions that could have the effect of barring a province from receiving equalization payments be excluded from the Fiscal Arrangements Act. The equalization formula should apply uniformly to all provinces without exception.

Established Programs Financing

Constitutionally, health care and education primarily fall under the jurisdiction of the provinces. Over the years, however, the federal government has become more and more involved, in response to public pressure for the development of countrywide health and education services that conform to accepted standards. The Royal Commission on Health Services observed in the early 1960s that health had become a matter of national concern that no enlightened government could ignore. At the time the Commission's report was published, the Hospital Insurance and Diagnostic Services Act was in force; the Medical Care Act followed a few years later.

The federal government has also been heavily involved in postsecondary education since the early 1950s. Without substantial federal support in one form or another, most provinces would have found it difficult to provide the desired level and quality of education for their rapidly expanding populations of young people. In addition, the federal government has contributed directly to scientific research and to studies in the humanities in the postsecondary educational institutions, to manpower training, and to the support of students in both undergraduate and graduate programs. Better education, improved skills, and more-intensive research contribute to Canada's economic growth, enable the Canadian economy to be more competitive in international markets, and improve the mobility and productivity of the Canadian labour force. In these ways, federal funding of postsecondary education helps to achieve national goals.

Up to 1977, federal-provincial agreements were based on shared-cost programs involving hospital and medical insurance plans. Under these programs, the federal government paid approximately half the costs, on the condition that the provinces would meet national standards with regard to accessibility, universality, and comprehensiveness of available services. Similarly, the federal government paid one-half or more of the provincial operating costs of postsecondary education institutions in each province, with no conditions or standards attached. In 1977, the Established Programs Financing legislation provided for block funding of health care and post-secondary education, which gave the provinces more flexibility in the allocation of funds within and between programs.

Current Issues and Options

Since the adoption of the landmark changes brought about by Established Programs Financing, the provinces have encountered no serious problems with these financial arrangements. Certainly, there have been no widespread demands on the part of the provinces to have the EPF program significantly revamped or abandoned. The federal government has expressed concern, however, over the increase in its transfers as a share of the EPF program costs and over the compatibility of block funding with the maintenance of national standards. In its presentation to the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements, the federal government advocated that the EPF arrangements be revised to provide an effective mechanism for requiring that provinces accept the national health care standards embodied in either the existing or new federal legislation.

Funding for the EPF programs comes from cash payments and tax-point transfers from the federal government to the provinces. As it stands now, the federal contributions will increase at roughly the same rate as the gross national product until, for each province, the value of tax-point transfers equals the value of cash payments.

Should the federal government decide that economic conditions no longer permit such growth or that its level of funding is too generous, it could negotiate a cut in EPF transfers. That would leave the provinces with essentially two alternatives: 1/ they could increase taxes in order to make up the loss of federal revenue, institute higher user fees, and/or incur larger deficits; or 2/ they could reassess their priorities – in health care, education, and elsewhere – and reduce their services accordingly. In either case, the brunt of the adjustment would fall on the provincial taxpayer or recipient of services. In turn, the federal government could apply the funds saved to reduce its deficit, to cut federal taxes, or to finance some other federal expenditures. A cut in federal government transfers would only shift the burden of costs from one level of government to another, with no guarantee of any real gain in national terms.

If federal-provincial transfers were not cut but were maintained at the levels provided at present under Established Programs Financing, three basic options would emerge: 1/ disentanglement of the funding by the two levels of government; 2/ a more gradual evolution from the status quo; or 3/ an extension of earlier cost-sharing arrangements. Each of these options is described below.

1 A substantial disentanglement of federal-provincial transfers would mean a partial, or possibly complete, replacement of EPF cash payments by unconditional transfers of tax points, along with associated adjustments in the Equalization Program. This option would be more in accord with the jurisdictional division between the two levels of government than any other option; and with a clearer separation of responsibilities, the potential for federal-provincial friction would probably diminish.

2 Evolution of the *status quo* implies that the federal government would continue to raise much of the revenue related to EPF programs and would continue to pay blocks of funds to provincial governments with few strings attached; however, it would have some power of suasion. On the provincial side, it implies that the provinces would continue to deliver the services, would have substantial control over the various programs, and would agree to certain national standards, or levels, of service.

The main advantage of this option is that it would not alter a system that now grants the provinces the flexibility they have demanded and one that leaves the door open for a stronger federal role should conditions make it necessary.

3 Cost sharing at present is not part of the EPF arrangements. This option could mean a return to the cost-sharing programs in existence prior to 1977. Also new types of cost-sharing schemes could be introduced. This might include new initiatives, in areas such as pharmacare and dental care, or possibly in the reallocation of some EPF payments to federal scholarships and research grants. While these new services would be delivered by the provinces, the costs of the programs would be more closely shared and the objectives more closely determined between the two levels of government.

The choice between these three options is difficult because the underlying issues are complex. They are intertwined with the history of Canadian federalism, with the question of federal-provincial jurisdiction,

with the inability of the lower-income provinces to finance the necessary services from their own resources, with the reluctance of the higher-income provinces to carry more of the burden of provincial equalization, and with the unfavourable economic climate that is constraining the revenue capacity and expenditures of the federal government. The choice of options will likely differ between the federal and provincial governments because their political goals and economic priorities are not necessarily the same.

From the analysis in Chapters 6 and 7, the Council concludes that the provinces, for the most part, have not taken undue advantage of the increased flexibility of Established Programs Financing to reduce their spending on health, higher education, and related programs. Some spending restraints have occurred, but generally they appear to be in line with EPF objectives. The analysis also shows that some major changes have taken place in the type and range of health services, but these changes, too, could be expected under the more flexible arrangements of EPF funding.

At present, there is no legal requirement under the EPF arrangements to separate the funds for post-secondary education from those for health care, nor has there been any undertaking by the provinces to earmark funds from the federal government for either purpose (or for EPF programs, for that matter). The federal government follows the convention of dividing up the EPF financing among the programs and of even issuing the cash portion in three separate cheques to each province. In comparing the federal government's designation of funds with the expenditures on the various programs by the provinces, some observers have arrived at conclusions about the trends in the sharing of program financing between the federal government and the provinces. It has been claimed, for example, that the federal government pays more than half of the operating costs of postsecondary educational activities and that this share has increased since 1977.

Because of the complexities and the differing viewpoints, there is no way to settle definitively the arguments about trends or fairness in the fiscal arrangements as they now apply to postsecondary education. The conditions and undertakings are even more hazy than they are for health care. In a broad qualitative sense, there is widespread agreement that some remarkably good developments in postsecondary education have taken place in Canada over the past quarter century and that both the federal and provincial governments deserve credit for these accomplishments. It is also agreed that in virtually all provinces (more so in some than in others) the generosity of postsecondary education funding by provincial governments has declined in recent years. But to attribute this to provinces having taken advantage of the flexibility in the EPF arrangements to squeeze their universities and colleges is to ignore the other important factors influencing educational developments.

Despite these complexities, the Council believes that federal-provincial transfers for health care and postsecondary education should be maintained at this time. Furthermore, we believe that the provincial expenditures under Established Programs Financing should be monitored more closely in order to lay the basis for a system of greater accountability with respect to the magnitude and the employment of funds transferred to the provinces. Over the longer run, such an approach would help to settle the issue of how the federal government might reasonably exert tighter controls on service costs in order to ensure "national standards."

Health Care

Hospital care, medical care, and extended health care account for a large part of federal-provincial transfer payments. Concerns have been expressed that health care will become less accessible to Canadians as costs escalate and as governments tighten their belts; that the transfers from the federal government will not be sufficient to meet provincial expenditures; and that today's level of health care would not, or could not, be maintained if the federal government were to relinquish its role of financial assistance. In view of these concerns, it is important that the public be better informed about the performance of the Canadian health care system. In particular, the public needs to be informed about such items as the amount of federal transfers to the provinces; the provincial variations in per capita expenditure levels; the sources of provincial disparities in levels of service; the changes in costs per capita over the years; the sources of cost increases; and the state of health of Canadians, as measured by a variety of health indicators.

In the review of hospital expenditures, wide variations were observed in per capita operating expenditures among the provinces. These variations were attributed to provincial differences in patient-days per capita and costs per patient-day. They, in turn, were traced to provincial differences in the age distribution of the population, in hospital admission rates, length of hospital stay, labour hours per patient-day, and wage rates per hour. Furthermore, it was shown that these provincial variations have widened in recent years. On the basis of currently available data, this kind of analysis could be extended to show by how

much the levels of service differ in different institutions, why they differ so much, and to what extent the provincial levels of service change over the years.

Our analysis also underlines the provincial variations associated with physicians' services. For example, the volume of physicians' services, measured on a per capita basis, is substantially lower in some of the Atlantic provinces than in other provinces. This is not because the productivity of physicians is lower in those provinces – it was actually found to be higher – but primarily because the number of physicians per capita is lower. Moreover, there are significant provincial variations in the extra billing of patients by physicians and in the extent to which they have opted out of the system. The latter variations are at present not nearly as great as those in provincial per capita services, but because such practices could lead to a serious erosion of the accessibility of the public health care system in the longer run, we believe they should be regularly monitored through the review of publicly available information.

Established Programs Financing enables the provinces to allocate funds from the federal government more nearly in accord with provincial priorities. With a rising gross national product, the per capita funding of provincial health expenditures is being gradually increased. These increases are designed to accommodate wage and price inflation and, at the same time, allow for some real improvements in the quantity and quality of service over the longer term. Established Programs Financing also provides the provinces with additional funding for extended health care. These funds are being allocated by the provinces to a variety of services. As indicated by the analysis, provincial variations in expenditures on these services are even greater than those on hospital or physicians' services. With a rising gross national product, federal funding for extended health care services is likely to be increased in the same manner as funding for the other health services.

While it is not possible at present to quantify all aspects of health services, enough data are being collected on hospitals and mental institutions to account more clearly for the provincial variations and the sources of change in provincial expenditures and services as they occur over the years. Statistics Canada has collected data on hospital expenditures and services, as well as on mental institutions, for many years. Data on extended health care services, however, have only been collected since 1976 and are not published annually. Data on physicians' services are not being collected by Statistics Canada but by the Department of Health and Welfare Canada. Data in these different areas of service are not all of the same quality or equally accessible. If health care standards and levels of service were to be monitored more closely, the quality of, and access to, provincial data would need to be improved in certain areas, particularly in that of extended health care.

As a first step in the process of providing for greater accountability, we propose that the transfers by the federal government to the provinces under EPF for health care and postsecondary education be allocated separately so that the manner in which those funds are employed can be more readily determined than at present. As a means of more closely monitoring developments over a wide area of concern with respect to health care expenditures and services, the Council concludes that it is essential for the federal government, in co-operation with the provinces, to establish a system under which all relevant and up-to-date statistics would be made available on an annual basis. This would include statistics on the operations of all hospitals and mental institutions, physicians' services, and extended health care facilities.

As a final step in the accountability process, we urge that the Minister of Health and Welfare Canada submit an annual report to Parliament on the operation of all facets of the health care system so as to provide a basis for consideration of the issues surrounding them by both the public and Members of Parliament.

For all of the above reasons,

6 We recommend the establishment of an improved and more comprehensive system of monitoring developments in all relevant areas of the Canadian health system in order to provide the basis for greater information to the public and to Parliament with respect to the efficiency and cost-effectiveness of federal transfer payments to the provinces. In particular, we propose:

- **that transfers by the federal government for health care and postsecondary education be designated separately; that the allocation of such funds be carefully tracked; and that a system of publishing provincial accounts and statistics for expenditures on health care be established;**
- **that timely and pertinent data be provided on health care expenditures and services covering hospitals, mental institutions, physicians' services, and extended health care facilities annually and, as far as possible, in integrated form so that they can be analysed and interpreted by the federal and provincial governments on a comparable basis;**
- **that extended health care facilities be monitored more closely by federal and provincial governments to ensure that some of the more**

basic services covered by this provision are available in all provinces on a similar basis;

• that provincial disparities and future changes in the service levels of physicians, together with the extent of opting out and of extra billing by physicians, be monitored on a continuing and non-confidential basis; and

• that the Minister of Health and Welfare Canada table in Parliament an annual report on the performance of the Canadian health care system so that all information pertaining to federal-provincial funding, levels of service, accessibility, provincial disparities, and quality of service will go on public record and the issues surrounding them will be open for public and parliamentary debate.

It is probably fair to say that at the time of the enactment of Established Programs Financing in 1977, the health services of all ten provinces conformed to the basic conditions of accessibility. To attain greater flexibility in the provincial allocation of funds for health care, the federal government and the provinces agreed on cash and tax transfers. Complete reliance on tax transfers was unacceptable to the federal government because elimination of conditional cash transfers could have eroded the basis for preserving the existing standards of service. For example, user charges in a province could have been raised to excessively high levels. Without "conditional" cash transfers from the federal government to the province, it would have been difficult, if not impossible, for the federal government to have arrested the growth of such user charges. There is no reason to believe that this is not as true today as it was in 1977.

Therefore,

7 **We recommend that the federal government continue to provide cash transfers for part of the funding of provincial health insurance so that reasonable standards of accessibility will be assured in future.**

As demonstrated in our analysis, part of the provincial variations in the cost of hospital services stem from provincial differences in the age distribution of the population. According to our estimates, such differences account in some cases for more than 20 percentage points of the provincial variations in length of hospital stay, and they suggest that hospital costs in some of the provinces are substantially higher than in others because of the age factor.

Consequently,

8 **We recommend that, to the extent that provincial variations in age composition give rise to provincial differences in hospital costs, the distribution of the cash transfers from the federal government to individual provinces be adjusted to take account of such age differences. This should be done without increasing the total costs of the program.**

Education

Postsecondary education is perhaps one of the most contentious areas of federal-provincial relations. Education is primarily under the constitutional jurisdiction of the provinces, and in all provinces – particularly Quebec – it is considered a key element of cultural aspirations. At the same time, it must be recognized that provincial decisions on postsecondary education can have national implications, especially with regard to the mobility of people between provinces.

As it stands now, the federal government's role in postsecondary education is not clearly defined. Some of the federal commitments to funding postsecondary education programs are targeted to meet specific objectives in such areas as student aid and research grants, which provide effective levers for the implementation of federal policy. Other federal commitments, however, are not directly linked to such objectives. We are concerned about the lack of an established and clear federal role, however broad or limited it may be.

Therefore,

9 **We recommend that the federal government define and clarify its interests in, and potential influence on, postsecondary education before the next negotiations of the Fiscal Arrangements Act towards the end of the decade.**

Prior to 1977, part of the federal cash transfer to the provinces was for the purpose of funding postsecondary operating expenditures. Now it is an unconditional transfer and not linked to the actual level of provincial expenditures. We believe, given the sensitivities of the provinces, that the unconditional nature of federal cash payments is appropriate.

Accordingly,

10 **We recommend that the federal government, through its EPF transfer to the provinces, continue to provide strong support to postsecondary education. As long as provincial governments do not discriminate against students from other provinces or discourage student mobility in general, the federal contribution should remain unconditional.**

Provincial policies relating to postsecondary education have implications that reach beyond provincial boundaries. Some degree of interprovincial co-ordination is currently achieved through various academic associations involving postsecondary institutions and through the Council of Ministers of Education, Canada, which is composed of the ten

provincial Ministers. The federal government is not a party to this process of co-ordination, even though it makes substantial financial contributions to post-secondary education.

To remedy this shortcoming,

11 We recommend that the federal and provincial governments establish a formal and continuing dialogue for the purpose of improving federal-provincial co-operation on matters relating to postsecondary education policies.

Finally, the Council feels that issues of national concern in the area of postsecondary education should be debated in the Parliament of Canada. The Secretary of State should inform Members annually about the status of federal programs affecting postsecondary education.

Therefore,

12 We recommend that the Secretary of State table in Parliament an annual report on the effectiveness of federal programs relating to post-secondary education.

The Tax Collection Agreements and the Objectives of Tax and Fiscal Harmonization

An important objective in any federal state is that of fiscal harmonization. The aim is to establish fiscal arrangements that permit provincial governments to institute expenditure and income distribution policies according to their own individual priorities – policies that, at the same time, cause the least fiscally induced distortion in the distribution of the economy's resources.

Harmonization of taxation arrangements between the federal and provincial governments is an important method of attaining fiscal harmonization. Tax harmonization is primarily, but not exclusively, achieved in Canada by the Tax Collection Agreements between the federal and provincial governments. Under these agreements, the federal government collects personal and corporate taxes for participating provinces that agree to certain conditions – primarily to adopt the federal definition of what constitutes taxable personal income or corporate taxable income. All provinces except Quebec participate in the agreements with respect to personal income tax; all provinces except Quebec, Ontario, and Alberta participate in the agreements with respect to the collection of corporate income tax.

Our view of developments in the taxation arrangements between the federal and provincial governments over the last 40 years is that they have, by and large, been healthy. Since 1941, Canada has shifted from a system of complete centralization of personal and corporate income taxes to a much more flexible sharing of income taxes between federal and provincial governments. The increased flexibility that has been attained by the provinces in determination of their income taxes has not prevented them from maintaining uniformity in important areas of taxation practice – whether or not they are members of the Tax Collection Agreements. Thus all provinces agree to rules governing the allocation of individual incomes and corporate profits for purposes of provincial taxation, and these rules prevent double taxation of income and other problems that arose in the "tax jungle" of the 1930s.

At the same time, however, there have been some developments in the area of taxation that have been a cause for concern. The Council would like to address remarks and recommendations to two such issues: discriminatory taxation measures; and tax competition among provincial governments.

Discriminatory Taxation Measures

On several occasions in past years, provincial governments have attempted to institute taxation measures that would discriminate in favour of provincial residents who receive dividends from companies having headquarters in the province concerned. The federal government has refused to administer discriminatory tax proposals advanced by provinces that are parties to the Tax Collection Agreements. This prohibition, of course, does not apply to the provinces that are not parties to the agreements.

The economic case against these discriminatory measures is a classic one. They create barriers to the mobility of capital and goods within the nation. Such restrictions impede the allocation of resources to their most productive uses. From a practical point of view, the benefit of such discriminatory tax measures over the longer term is also open to question. To a degree, discriminatory tax measures are accepted in the "real" world as one way by which provinces can attract a greater share of economic activity. Carried to the extreme, however, such "beggar thy neighbour" policies can only serve to invite retaliation. More often than not, nobody gains in the end from these policies, and everybody loses because of the resulting "balkanization" of the economy.

The Council consequently welcomes the initiative shown by several provincial governments in support of a Code of Conduct that, among other things, would involve forgoing, by mutual agreement, discriminatory taxation practices. At the same time, however, we consider it important that any such Code of Conduct should take account of the fact that the goals of discriminatory tax measures can be

achieved equally well by other means. It is known, for example, that some of the discriminatory tax measures that the federal government has refused to administer on behalf of the provinces have their counterparts in the expenditure programs of other provinces.

For this reason,

13 We recommend that provincial governments, when seeking agreement on tax measures in the Code of Conduct, take into account the similarity between the effects of discriminatory taxation practices and those of some expenditure programs and regulatory measures.

It would be misleading to lay blame for balkanization of the economy solely on the provinces. Concern should be expressed, too, about federal policies that affect the free flow of goods, capital, and labour in the economy. The chief examples in the case of federal tax policy are special investment and employment credits provided under the Income Tax Act in regions characterized by high and persistent unemployment levels and relatively sluggish growth. Other incentives administered under the Department of Regional Economic Expansion are designed to direct new private sector investment expenditures to the same regions through funding of investment in new infrastructure, such as roads, and through grants and loan guarantees to businesses prepared to undertake new capital investment in these regions. It has been suggested that the federal government agree to accept, as part of the Code of Conduct or otherwise, some constraints on its own actions in this regard.

The Council interprets this suggestion as a call for more careful consideration of the effects of these federal policies on the efficient functioning of the Canadian economy.

Tax Competition among Provinces

For the most part, the Council sees less cause for concern with respect to other forms of tax differences between provinces. We note that provinces usually tend to avoid excessive differentiation in basic taxes on factors of production that are mobile between jurisdictions. Nevertheless, some of the differences in taxation that have emerged in recent years may be viewed as reflecting a legitimate attempt by the provinces to implement distributional objectives. Some of this differentiation may also be viewed as an example of healthy rivalry between jurisdictions.

The Council realizes that the prospect of tax "competition" does worry provinces faced with the prospect that other jurisdictions can provide similar levels of public services with much lower degrees of tax effort. A related concern is that reductions in corporate taxation may be used by the more wealthy provinces to attract business to their jurisdictions. These concerns have led to proposals to "federalize" the corporate income tax or at least to impose uniformity in provincial corporate tax rates.

The Council sees little merit in these proposals. They are, of course, unpalatable from the point of view of their implications for the autonomy of provincial governments. There is also the pragmatic fact that they would not work. The problems these proposals address arise because of differences in the financial capacities of provincial governments – differences that will remain a fact of life in Canada for some time. It would be useless to address some of the consequences of these differences in provincial financial capacities by attempting to impose uniformity in taxes. If wealthy provinces were determined to attract business away from other jurisdictions, they could just as easily do so by "expenditure competition" as by granting tax breaks to business.

Fiscal Arrangements and Stabilization Policy

There are strong arguments for federal-provincial co-operation in stabilization policy. These were discussed in some detail in the Council's 1977 Report, *Living Together*.[3] Briefly stated, the provinces cannot contribute to the conduct of effective stabilization policy without the co-operation and support of federal fiscal and monetary authorities. The Government of Canada, on the other hand, would have to rely on a dangerously narrow range of policy instruments if it were forced to conduct stabilization policy without the support of the provinces. These restrictions would result either in stabilization policy not being pushed far enough or in opportunities not being seized for the selective application of policy to particular regions or particular economic activities.

There are obvious ties between the fiscal arrangements and stabilization policies. They are negotiated by the same people in the same forums, and both substantially influence the pattern of revenues and expenditures as between governments. These interrelationships are clearly important. The willingness to co-operate in one area of economic policy is naturally influenced by the degree of co-operation evidenced in others.

Of considerably more importance, however, is the practical question of whether or not the relative roles of the federal and provincial governments that have emerged out of the fiscal arrangements have reduced the effectiveness of stabilization policy in Canada. Particularly since the report of the Royal Commission on Taxation [the Carter Commission] in 1966,[4] there has been some concern that growing provincial fiscal

power could reduce the effectiveness of federal stabilization policy, either deliberately or because of the inherent destabilizing features of provincial-local finance.

Special studies undertaken in connection with this report and our own analysis lead to the conclusion that the effectiveness of stabilization measures has not been undermined by the shift that has taken place to date in fiscal resources and responsibilities from the federal to provincial governments. There are several reasons why. In the first place, provincial government growth has been essentially at the expense of the private sector, not the federal government. By replacing the inherently less stable private activity, provincial government growth has reduced the scope for economic fluctuation. Nor does the empirical evidence of the last 15 years in Canada support the argument that provincial and local government budgetary activity has been perverse. In other words, these budgets have not added significantly to demand during peak periods nor to decline in recession and, therefore, have not worked against stabilization measures at the federal level. Moreover, the main areas of provincial spending growth – education, hospital care, and medical care – generally do not follow such cyclical patterns and adjustments. Finally, changes in the structure of both taxes and expenditures at the federal level have, in fact, increased the built-in stability of the federal budget. These conclusions apply to stabilization issues arising from cyclical variations; structural adjustments raise other issues that have to be considered as specific cases.

Section 2 of the Fiscal Arrangements Act contains a specific provision related to stabilization. That section ensures that if provincial tax yields other than from resources decline for economic reasons, federal payments will be increased sufficiently to enable provincial services to be maintained at the level existing a year earlier. This provision has been a feature of the fiscal arrangements since the 1950s, although no payment has been made under it. Its chief effect may be to improve the credit rating of smaller provinces by providing a federal guarantee of cash flow. Thus, while supportive of economic stability and a feature of the arrangements worth maintaining, this provision is not an active instrument of economic stabilization.

Over the past several years, there have been a number of suggestions that provisions be made in the fiscal arrangements to allow for more active participation by provincial governments in the conduct of economic stabilization policy. The Carter Commission, for example, proposed that the federal government take steps to increase its transfers to the provinces during a recession and to decrease them in times of excessive economic growth. Others have suggested that the federal government should be prepared to purchase bonds issued by the provinces at the prevailing federal interest rate in order to help finance expansionary provincial measures during periods of slow or declining economic growth.

On the basis of past experience, we do not believe that adoption of these suggested approaches is warranted. Our examination of the record indicates that, on balance, provincial governments have played a positive role in support of federal stabilization policy. In our view, any benefits that might be gained by taking steps to encourage greater provincial participation in the conduct of stabilization policy would be considerably outweighed by the additional measure of instability that would be added to the federal budget.

Most of these proposals for increasing provincial involvement in stabilization policy reflect a concern that the federal government's ability to continue to play a major role may have been undermined by the substantial shift that has taken place in the proportion of revenues and expenditures under the control of provincial governments. Notwithstanding this shift, our analysis indicates that the federal government continues to have at its disposal the tools needed to conduct stabilization policy effectively. A further major finding of our analysis is that a shift in the responsibility for the financing of the EPF program – for instance, by the federal government transferring tax room to the provincial governments in place of existing cash transfers – would have minimal implications for the conduct of stabilization policy. We conclude, therefore, that the issues of stabilization policy and of fiscal decentralization can be regarded as separate and unique.

The Politics and Process of Fiscal Arrangements

The complex intergovernmental machinery established to undertake negotiation of the fiscal arrangements at five-year intervals is indicative of the high degree of interdependence among governments in Canada. While, in general, the provincial and federal governments have developed quite autonomous and independent roles in economic and social policy making, the programs under the fiscal arrangements have been achieved largely through a complex intergovernmental process characterized by consultation, co-operation, and compromise. In large part, this decision-making process reflects the considerable extent to which the programs themselves are subject to shared responsibilities in areas relating to

taxation, hospital care, medical services, postsecondary education, and the level of government services in general.

Democracy and Effectiveness in Decision Making

In examining the process of reviewing the fiscal arrangements, the Council analysed criticisms questioning the democratic nature and effectiveness of policy making. These criticisms are usually raised with respect to intergovernmental affairs in general, but we specifically applied them to the fiscal arrangements. In our view, the major problems relate to the level of openness and participation in the process, although the nature of our parliamentary system and of financial legislation must be taken into account when considering these problems.

To a considerable extent, the various committees established for the negotiation of intergovernmental arrangements meet behind closed doors. Traditionally, information has not always been made available in advance to legislative members, or the public at large, about the issues under negotiation; moreover, little or no opportunity has been provided for them to express their views on the matters in question, despite the fact that their interests may be vitally affected by the outcome. Furthermore, insufficient information has been made available on the actual working of the arrangements that have been arrived at through this process of closed negotiations; nor has there been as much opportunity provided as there might have been for legislative bodies, or the public, to review and comment on the resulting effects of such arrangements.

Federalism and the Quinquennial Review of the Fiscal Arrangements

The Council also examined how the reviews of the fiscal arrangements affected the respective responsibilities and powers of governments in Canadian federalism. We did not feel it appropriate to make recommendations in this area, because broad political judgments are required, as well as a general appreciation of the workings of the Canadian state, both of which are beyond the Council's responsibilities. Nevertheless, the conclusion was reached that it was desirable to raise these issues for public discussion, especially since in the current negotiations the federal government has linked the notion of a "fiscal imbalance" with the concept of a "political imbalance." In June 1981, Finance Minister MacEachen argued before the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements that the fiscal strength of the provinces as a whole had substantially increased their political leverage.

While the Council does not take any broad position on the appropriate roles or balance of power among governments in Canada, our analysis of the intergovernmental process involved in the review of the fiscal arrangements provides a basis for some comments on the issue. The main point to be made is that governments function in a complex, economic and social milieu that encourages a high degree of interdependence and does not easily permit the classification of roles and responsibilities without overlap and ambiguity. The formal powers of governments in a federal state may be initially designed in a constitution, but, after that, the political and legal process actively redefines the powers to be held by governments in response to economic and social changes.

The reviews of the fiscal arrangements display this pattern of overlapping, ambiguity, and interdependence regarding the respective responsibilities of the two levels of government. Despite the considerable legal powers that the federal government has under the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, an elaborate system of intergovernmental co-operation and consultation is in place. In strictly legal terms, the federal government can act unilaterally to change the programs in the fiscal arrangements; in practice, however, no one level of government has yet dominated the other because each comes to the table armed with *real* bargaining power.

Reform of the Process

Looking to the future and possible reform of the process, the establishment of the federal Parliamentary Task Force prior to the current negotiations on the fiscal arrangements represented an innovative means of increasing openness and public participation. For the first time in Canadian history, a public forum was provided through meetings of the Task Force across the country for discussion and review of the fiscal arrangements by affected groups and individuals. Members of Parliament themselves were also given considerable opportunity to express their own conclusions in advance of the negotiations among governments.

As a step towards resolving the problems of the level of openness and participation in the reviews of the fiscal arrangements, we believe that the federal and provincial governments should make use of committees similar in nature to the Task Force. Either existing standing committees or specially created task forces should be charged with the responsibility of studying in advance all intergovernmental arrangements that are to become the subject of negotiations during the review of the fiscal arrangements. These

committees should have the power to hear the views of all concerned groups.

Accordingly,

14 We recommend that Parliament and legislatures in Canada empower committees to review and monitor issues of importance to the fiscal arrangements and to consider the views of representative groups in advance of each quinquennial review.

Another important step towards a more open review involves the availability of information. It is the Council's belief that the technical information prepared by bureaucrats as background for negotiation of the fiscal arrangements should be accessible to the committees proposed above and to the public. We recognize that the negotiations require a certain degree of confidentiality with respect to the policies and positions of each government if true bargaining is to occur. By the same token, however, as a general rule we consider that much of the technical information can, and should, be made available.

Therefore,

15 We recommend that federal and provincial governments ensure that sufficient information is forthcoming to Parliament, provincial legislatures, their committees, as well as representative groups in order that they have a full opportunity to review the fiscal arrangements both before and after negotiations. Partially to fulfill the obligations of this recommendation, the Council urges the federal and provincial Finance Ministers to report to their respective legislatures and committees before and after the negotiations.

Having suggested some rather modest adjustments to the process, the Economic Council believes that the fiscal arrangements should continue to be reviewed regularly in a way that is effective but yet in a spirit consistent with parliamentary democracy and federalism in Canada.

Dissent and Comment by Pierre Lortie

Dissent on Established Programs Financing

My dissent concerns Recommendations 6, 7, and 12 in the section of the report on Established Programs Financing. In my view, these recommendations are based on an approach to the organization of the Canadian polity that is at odds with Canada's constitutional framework and with the views of many Canadians as to the structure of the system that will best deliver these programs.

At the outset, I should state that these recommendations by the Council are simply not warranted. First, they do not derive from the research findings presented in the chapters describing the Council's research and methodology. Second, they amount to a complete reversal of the agreements that the federal government reached with the provinces in 1977. It should be recalled that on June 14, 1976, Prime Minister Trudeau proposed to replace the existing cost-sharing arrangements for medical care, hospital insurance, and postsecondary education by a new system, Established Programs Financing. This system had the advantage that contributions would no longer be tied to provincial expenditures. The rationale behind these proposals arose from a desire to better match the revenues of each level of government with the primary responsibilities assigned to each level under the Constitution of Canada.

In my view, nothing has happened during the ensuing period that would call into question this fundamental policy direction. In fact, the evidence contained in the Council's research indicates that Established Programs Financing has worked well. With respect to the options available, I would have preferred consideration of further substantial disentanglement of federal-provincial programs. This disentanglement could be achieved through replacement of some of the present cash payments by an unconditional transfer of tax points, supplemented by adjustments in the Equalization Program.

Many arguments have been put forward against such a course of action. For example, it is often asserted that the federal government cannot possibly transfer more resources to the provinces. In my opinion, these arguments are not well founded. The federal government has already agreed to support and finance these programs, which are under the jurisdiction of the provinces. As a result, the federal revenues are earmarked and are no longer available for other federal programs. The issue at stake, therefore, is not the amount of resources but the method used to effect the transfer.

In considering this latter issue, I firmly believe that the accountability of governments is enhanced when each level is forced to raise the taxes required to support its own expenditure programs. This is one of the obvious merits of the 1977 agreement and it should not be destroyed. To the contrary, I think that accountability of governments in Canada would be improved if further disentanglement was pursued.

The argument that the federal government needs these resources to conduct a more efficient macro-economic policy is really a delusion. Federal initiative in macro-economic policy areas requires the ability to shift resources; only then does it have effect at the margin. Here again, since the resources are already committed to the programs under Established Programs Financing, they are locked in and in the short term are no longer available for other federal policies. One could even make a good argument that the federal government has been overly stubborn in treating these expenditures as its own resources and in promising to provide a high level of payments to the provinces. In the past, this stubbornness has limited the federal government's ability to conduct other national policies and has unnecessarily raised tensions within the Canadian federation.

It should be stressed that being strong is not synonymous with being "fat" or "inflated." Yet, that is effectively the stance of those who state that the federal government needs to collect the taxes required to finance Established Programs Financing.

A second argument supporting the federal government's role in Established Programs Financing stems from the need to ensure the accountability of the federal government. This argument in my view is also fallacious. First, the involvement of the federal government in programs under these areas of jurisdiction was, and still is, based on the "spending power" (that is, the assumed power of the federal government to make payments to persons, institutions, or governments for purposes and matters over which it does not necessarily have the power to legislate). It is incorrect, however, to assert that the federal government must define policies in areas where it does not have the power to legislate once it has entered those fields using its spending power. Such a reasoning is circular. In the case of Established Programs Financing, the real answer to this problem of accountability is that there should be further disentanglement of the responsibilities of each level of government, not blurring further the responsabilities of respective governments.

The issue of national standards should also be addressed when considering Established Programs Financing. In current debates, this issue is often overblown. The fact that the federal government shares in the financing of some major programs does not mean that national standards will necessarily emerge. As a matter of fact, no agreement on national standards has yet been reached on Established Programs Financing, whereas national standards exist for the Canada and Quebec Pension Plans. Thus, it is a fallacy to state that the establishment of national standards derives naturally or automatically from funding. Such standards can only be achieved if there exist a political will and a thorough understanding of the policy issues and their implications. When these conditions exist, it is safe to assert that the federal government will have enough leverage to secure an agreement on reasonable national standards.

I should also mention that it is my belief that many of the federal papers and documents published on Established Programs Financing contain many naive views of the management of complex programs and institutions. We all know from past experience with the Post Office and the Canada unemployment insurance system that the federal government is not a particularly good example of how complex programs or institutions should be managed. Moreover, the idea that the federal government should finance infrastructures while the provinces should finance the on-going administrative costs (such as recommended by the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements)[1] is clearly unwarranted. This idea clearly contradicts any well-understood concept of accountability. If the provinces opt for maintaining tight financial reins on the growth of expenditures for these programs, for example, it is untenable for the federal government to encourage greater expenditures at the same time.

The major problem facing management of the programs under Established Programs Financing is how to enhance productivity and efficiency in the delivery of these services in a way that will better serve the needs of Canadians. This requires strong management on the part of provincial authorities. Parliament and the federal government should not destroy or undermine these efforts by becoming the spokesmen for certain special interest groups. In my view, this will be the outcome of the Economic Council's recommendation asking for annual debate and ministerial statements on the management of these programs in the House of Commons.

The Council report also states that better comparative data and information are required to permit a greater understanding of these programs. This data base would allow for more informed judgment on the efficacy of the program's management and for more enlightened policy debate. I agree with this view of the Council. I submit, however, that the stated objectives would be better served if this task were to be performed by a "neutral" agency rather than by a policy department. There are too many risks that a policy department would produce a data base that fit its own objectives instead of one that could be used by all concerned. In turn, this will destroy many advantages accruing from a national data bank and will rapidly turn this discussion to an acrimonious debate.

Comment on Discriminatory Taxation Measures

The ideals expressed in the Council report on tax harmonization are laudable; the analysis, however, presents a truncated view of the effects of provincial and federal policies on the redistribution of government activities across this country. The analysis ignores how the overall impact of federal tax policy decisions can have an inordinate effect on one area of the country at the expense of other areas.

Examples applicable to all provinces can be found to demonstrate the way that federal taxation measures can affect one province differently than others. A

1 Parliamentary Task Force on Federal-Provincial Fiscal Arrangements, *Fiscal Federalism in Canada* (Ottawa: Supply and Services Canada, 1981).

recent report by Quebec's Department of Finance[2] shows that the effect of the federal tax structure in terms of personal income, considering the socio-demographic characteristics of the Quebec population, results in more burdens for Quebec residents than for residents of other provinces. Another example often cited is the federal Registered Home Ownership Savings Plan, which does not take into account the habits of Quebec residents. One could also point to the tax treatment of oil and gas expenditures and the geographical impact of these measures, especially in comparison with the less favourable tax treatment of investment in the manufacturing sector.

By definition, economic policies are meant to discriminate. It is misleading to single out one type of policy as unacceptable, while forgetting the overall impact of national policies developed by the federal government. The relevant issue is the setting of policy objectives and the selection of the various instruments used to achieve them.

2 Quebec Department of Finance, *Les préférences fiscales du régime d'imposition au Canada* (Quebec: Government of Quebec, October 1981).

Appendix A

Some Empirical Evidence on the Interrelationship of Equalization, Fiscal Structure, and Internal Migration

The Role of Empirical Evidence with Respect to the Relationship between Internal Migration and Fiscal Structure

In Chapter 3, it was pointed out that failing to equalize *all* fiscal benefits could lead to the inefficient allocation of labour in the country because of the influence that fiscal benefits have on migration decisions. For example, it was argued in Chapter 3 that if provincial ownership of natural resources is accepted, then equity considerations do not call for the full equalization of provincial expenditures financed by natural resource revenues. This, however, has an efficiency cost *to the extent* that migrants are attracted by that part of natural resource revenues which is not equalized.

If decisions by Canadians to migrate from one province to another were not influenced by regional differences in fiscal benefits, it is apparent that these differences would not be a matter of concern from the viewpoint of economic efficiency, but only in terms of equity. Thus it is clearly essential, for the design of good policy, to know whether differences in the fiscal structure of the provinces are, in fact, significantly related to the migration decisions of individual Canadians.

Broadly speaking, our analysis indicates that migration is affected by differences in fiscal benefits and, therefore, considerations involving efficiency *are* relevant to policy choices relating to the fiscal arrangements.

Before summarizing the results of this research, however, it is useful to outline the recent migratory trends in Canada and to assess roughly the part that fiscal factors may have played in the migratory flows.

The Recent Migratory Trends in Canada

The past 15 years have witnessed a marked turnabout in migratory movements in Canada, as shown in Table A-1. After decades of net out-migration, which reached a peak of 118,000 between 1961 and 1971, the Atlantic provinces experienced a migratory inflow during the early 1970s. At about the same time, the traditionally heavy inflow of people from other provinces into Ontario began to decline, and the outflow began to rise, with the result that by 1974 Ontario experienced net out-migration. Alberta, which had experienced four successive phases of positive and negative migratory balances since the beginning of the 1950s, entered a period of strongly positive net migration in the 1970s. This time, however, in-migration has proceeded at exceptionally high rates, by historical standards, and has amounted to more than 1 per cent of the provincial population annually ever since 1974.

After examining the "long swings" in provincial migratory balances, Professors R. W. Boadway and A. G. Green, in a recent study published by the Economic Council, concluded:

> There has been a "shift" in historic migration patterns. This is the first time in the last century [in the 1970s] that we have observed in Canada, simultaneously, an exodus from the Central Provinces and a net inflow to both Alberta (and British Columbia), and the Maritime Provinces.[1]

At first glance, one might conclude that these variations in migratory trends were at least partly due to changes during the same period that affected the fiscal structure of the provinces concerned. The flow

Table A-1

Quinquennial Net Interprovincial Migration,[1] Canada, by Province, 1951-80

	1951-55	1956-60	1961-65	1966-70	1971-75	1976-80
			(Thousands of persons)			
Newfoundland	-3.9	-6.7	-12.6	-19.8	4.1	-6.8
Prince Edward Island	-6.3	-2.4	-2.1	-3.1	2.7	1.7
Nova Scotia	-11.6	-15.2	-21.5	-16.5	10.6	1.3
New Brunswick	-20.5	-8.2	-20.7	-21.5	17.2	6.2
Quebec	-44.9	-31.2	-19.1	-116.3	-81.8	-154.8
Ontario	85.6	68.9	70.2	152.1	-23.5	-53.6
Manitoba	-19.2	-21.8	-24.0	-50.5	-30.4	-49.1
Saskatchewan	-40.1	-50.0	-37.2	-78.9	-37.9	10.4
Alberta	11.2	18.5	-2.6	25.1	49.8	146.3
British Columbia	49.7	48.1	69.6	129.4	89.2	98.4

1 Excluding moves to or from the Yukon and Northwest Territories.

SOURCE S. Winer and D. Gauthier, "Internal Migration and Fiscal Structure: An Econometric Study of the Determinants of Interprovincial Migration in Canada," a background study prepared for the Economic Council of Canada (forthcoming).

of people to the West may have been partly triggered by the sharp climb in world oil prices that began in 1973, which produced considerable growth in natural resource rents, a portion of which was passed on to the residents of Saskatchewan, British Columbia, and particularly Alberta through the fiscal systems of these provinces. Alberta, for example, is alone among the provinces in levying no sales tax; it has the lowest personal income tax rate in the country; and it has provided for future financing of public services through its tax-exempt Heritage Fund, the value of which could reach $15 billion by 1984.[2] The recent positive migratory balance for the Atlantic provinces, resulting in large part from a sharp drop in out-migration, might be to some extent the result of changes in the federal Unemployment Insurance Act. These revisions to unemployment insurance extended the benefit period (as of 1972) and made it relatively easier to qualify for benefits (as of 1977) in regions where the unemployment rate exceeds the national average. During the 1970s, the financial resources of the Atlantic region were also expanded through increasing per capita equalization payments and other intergovernmental and personal transfer programs.

It is obvious that some economic factors not directly related to government activity, such as the 1970 and 1975 recessions in Ontario and the recent rapid growth of employment in the West, contributed to the decline in net in-migration to Ontario and in net out-migration from the Atlantic provinces, as well as to the increased net inflow to the West. Although our interest is in the relationship between migratory movements and fiscal structure, an analysis of the extent of fiscally induced migration must also take into account the influence of other "private" economic factors in determining migration.[3] Indeed, it is probable that people are overwhelmingly concerned with job prospects when choosing between different provincial labour markets and that the differences in net fiscal benefits available to potential migrants from the public sector are only of secondary importance in any explanation of total migration flows. In fact, the research carried out on the nature of migration decisions indicates that "private sector" influences, such as employment opportunities, explain a large part of the interprovincial migration. Since, however, there are plausible grounds for associating recent variations in migration with changes in fiscal structure, it is reasonable to analyse to what extent fiscal factors have influenced migratory trends.

Previous Research and a Summary of Results

Although many studies in the past have analysed internal migration in Canada, most have examined only the non-governmental forces that have induced people to move from one region to another. The only available evidence on fiscally induced internal migration is that found in a study by Professor T. J. Courchene of the University of Western Ontario.[4] In considering "public" determinants of migration, Courchene concluded that such fiscal variables as equalization and unemployment insurance payments did contribute to reducing mobility. This conclusion is of a general nature, however, and Courchene's analysis does not allow for a breakdown of the results on a regional basis.

For example, assume that part of the current migration to the West is motivated by the goal of capturing natural resource rents transmitted through the fiscal structure of the provinces in question, while intergovernmental transfers and unemployment insurance benefits have greater influence on migratory movements from the eastern provinces. The kind of analysis undertaken by Courchene does not adequately take into account this type of case. Courchene, in fact, did not consider the effects of western resource revenues on interprovincial migration because the data he analysed preceded the huge increase in petroleum prices that began in the early 1970s.

To overcome these difficulties, empirical analysis was undertaken on a regional basis, employing more recent data, which took into account a more complete selection of fiscal variables. The analysis has been further broadened through the development of data categorizing migrants by income groups, which facilitates a determination of the relationships between migration and fiscal factors. There are strong reasons for believing that the impact of fiscal structure varies systematically across income groups and that migratory patterns may also vary in the same way.[5]

A summary follows describing the results of the statistical analysis of certain elements of fiscal structure that were found to have been significant in explaining interprovincial migration flows.[6]

Western Natural Resource Revenues

The research data indicate that the expectation of fiscal benefits generated by natural resource revenues in Saskatchewan, Alberta, and British Columbia (and possibly also the expectation of provincially financed job opportunities) has played a significant role in attracting low- and middle-income individuals to these provinces.[7]

More precisely, the research allowed for the effect on migration decisions of the differences across regions in current employment opportunities and in

current incomes, for persons who are employed or unemployed, as well as for such factors as relative housing prices. Nevertheless, the expectation of fiscal benefits generated by resource revenues still plays a significant role in explaining the recent interprovincial migration flows.

Hence greater equalization of natural resource revenues could have important implications for migration in the future, a conclusion that is reinforced by the results on the role of equalization outlined below. But the very poor (those having low incomes and paying no income taxes), as well as the high-income persons, are not so clearly attracted by the expectation of fiscal benefits generated by resource revenues. A likely explanation for the results concerning the poorest group is the discouraging effect of the relatively high housing prices in the West. The migration data indicate that, for this group in particular, such high prices have significantly impeded in-migration to Alberta and British Columbia and have discouraged out-migration from the Atlantic provinces.

Equalization through Unconditional Federal Grants

The potential importance of changes in the equalization formula for the migration patterns noted above is reinforced by the following results:

- Unconditional grants have significantly slowed the out-migration of low-income groups from the rest of Canada to Alberta and British Columbia.[8]

- Since the existing system of unconditional federal transfers to provincial governments has played a significant role in halting migration to the West, which would otherwise have taken place in response to regional variations in such factors as wage differentials, it is clearly important, from the point of view of economic efficiency, to consider carefully the treatment of natural resource revenues in the equalization formula.

- With respect to migration *from* an Atlantic province, the fiscal consequences of unconditional federal payments, such as equalization, appear to have had a significant effect in retarding out-migration, but only for low-income people and only when other Atlantic provinces are included in the sample as destinations in addition to the six provinces west of the Atlantic region. The results also indicate that migration of low-income individuals *to* the Atlantic region is significantly encouraged by the equalization payments accruing to these provinces.

Regional Variations in the Benefit Pay-out Periods of the Unemployment Insurance System

The regional variations in the benefit pay-out periods of the unemployment insurance system appear to play a significant role in the migration decisions of Canadians. This is particularly so for persons in the low-income group contemplating a move from the Atlantic provinces and for those in the middle-income group considering a move to the western provinces of Alberta and British Columbia. The results indicate that where benefit provisions become more generous, they tend to discourage out-migration. But potential migrants also appear to be prepared to move to other areas where similar benefit provisions have become available.

Thus regional variations in the unemployment insurance system tend sometimes to reduce, and sometimes to increase, mobility. In some cases, unemployment insurance increases migration by reducing the net cost of searching for highly paid jobs in areas of high or increasing unemployment. Simulations on the quantitative importance of fiscal structure (to be presented below) indicate that, on balance, the effect of unemployment insurance in encouraging migration dominates in the case of inflows to Alberta and British Columbia, whereas the retarding effect dominates in the case of out-migration from the Atlantic region.

To summarize the above results, it can be said that:

1 Fiscal structure has significantly influenced migration decisions; however, the influence varies considerably by income group and region.

2 Fiscal structure generally tends to influence significantly low- and middle-income, but not the higher-income, Canadians in their migration decisions.

3 Fiscal structure appears to be more important in determining gross out-migration from the Atlantic provinces and gross in-migration to Alberta and British Columbia than it is in determining gross flows in the opposite directions.

This evidence casts serious doubt on allegations that such aspects of fiscal structure in Canada as equalization or provincial resource revenues have no significant migration implications.

An Estimate of the Quantitative Importance of Fiscal Structure

This section presents some estimates of the quantitative impact of selected changes in fiscal

structure on interprovincial migration. In addition to providing a general sense of the order of magnitude of this quantitative impact, these simulations also yield interesting information about the role of specific fiscal variables. For example, as noted above, they indicate whether the migration-enhancing or the migration-retarding effect of regional variations in the unemployment insurance system dominates in particular migration flows. While the results summarized above also indicate that migration of both poor and middle-income groups have been influenced significantly by fiscal structure, the simulations below suggest that fiscal structure has quantitatively influenced the poor to a much greater extent.

These simulations are directed towards answering the following question: What was the impact on migration rates of the changes that occurred between 1971 and 1977 in western natural resource revenues, in the system of equalization payments, and in the unemployment insurance system? Specifically, how do migration rates compare with what they would have been if, in 1977:

– western natural resource revenues had remained at their 1971 level (this is equivalent to a situation in which increases between 1971 and 1977 in resource revenues would have been shared equally across the country on a per capita basis so that they would not have been the cause of differences in net fiscal benefits across regions);

– equalization had remained at its 1971 level, thus eliminating the increase that occurred in these transfers, for whatever reason, between 1971 and 1977; and

– the post-1972 regional variation in the maximum number of weeks for which unemployment insurance benefits could be received had not been in effect?

For the purpose of this exercise, all other migration determinants besides the three listed above were maintained at their 1977 levels.

As indicated above, fiscal structure appears to be most relevant to out-migration from the Atlantic region and to in-migration to Alberta and British Columbia. The results presented therefore pertain only to the simulations of these two samples. First, an estimation was made of out-migration rates in 1977 for each province-of-origin/province-of-destination pair considered. Second, new estimates of migration rates were calculated by taking into account the changes in fiscal structure listed above. Third, percentage changes in migration rates between the two series were then computed for each "origin/destination" pair of migration flows.

The results of these simulations are summarized as follows:[9]

The Atlantic Region

Consider first the results for out-migration from the Atlantic provinces, beginning with the role of natural resource revenues.

The expectation of fiscal benefits generated by western natural resource revenues clearly stimulated out-migration from the Atlantic region. The results of the simulations indicate that, in 1977, migration rates from the Atlantic provinces to Saskatchewan and Alberta for the low-income group were between 40 and 65 per cent higher than they would have been had western natural resource revenues remained at their 1971 level. The corresponding increase for the middle- and high-income groups varied from 20 to 30 per cent.

With respect to the role of equalization, the results are somewhat more complex. The effect of equalization on rates of migration is ambiguous, depending on which sample (including or excluding moves between the Atlantic provinces) is used in the simulations. The "best" results (i.e. those in accordance with theoretical prediction) in the case of migration from the Atlantic region to other provinces show, however, that equalization grants would have retarded the migration of low-income persons to all destinations except Manitoba (which also receives substantial equalization payments). For example, in the case of out-migration to Ontario (the most preferred destination for out-migrants from the Atlantic region), the simulations indicate that the increase in equalization payments to the Atlantic provinces from 1971 to 1977 would have had the effect of reducing the out-migration rates of low-income persons by 5 to 13 per cent. Although these results are ambiguous, the quantitative role of equalization becomes clearer when simulations for in-migration to Alberta and British Columbia are considered, as will be seen below.

It was noted previously that the modifications in 1972 to the unemployment insurance system have had the effect of either increasing or reducing mobility. The simulations indicate, however, that, on balance, changes to the unemployment insurance system retarded out-migration from the Atlantic region to other provinces but increased it between Atlantic provinces. For example, the rate of out-migration to Ontario of low-income persons was between 35 and 42 per cent lower in 1977 than it would have been in the absence of any changes to the unemployment insurance system. When moves within the Atlantic provinces are considered, the effect of unemployment insurance on migration into

the destination province becomes more important; indeed, the simulation indicates that there was an *increase* of as much as 50 per cent in the rate of out-migration to other Atlantic provinces. For the middle- and high-income group, the reduction in out-migration rates to the six provinces west of the Atlantic region was only 5 or 6 per cent. This is much smaller than the corresponding reduction for the low-income group. The migration rates of middle- and high-income persons to other Atlantic provinces increased by about 20 per cent.

So it would appear that, at least for those in the low-income group, the regional variations in the unemployment insurance system over the 1971-77 period had a quantitatively important – and, on balance, retarding – influence on migration out of the Atlantic region to westward provinces. At the same time, the unemployment insurance system also substantially encouraged migration *within* the Atlantic region for all income groups.

When considered together as a package, the three fiscal changes discussed above seem to have retarded the out-migration of low-income persons from the Atlantic region to Ontario – the primary destination of migrants from this region. Rates of migration to Ontario for that income group decline by between 10 and 30 per cent approximately, depending on the province of origin. The rates of out-migration to resource-rich provinces like Alberta for that same income group do not decline to the same extent; in fact, in certain cases they increase substantially, by more than 20 per cent. This increase reflects the attraction of natural resource revenues discussed previously.

In contrast to the retarding effect on low-income persons, the composite effect of the three fiscal changes is to substantially increase out-migration rates for the middle- and high-income groups, except to Manitoba. This partly reflects the quantitatively weak retarding influence of the unemployment insurance system for this higher-income group.

Alberta and British Columbia

Simulations for migration from the rest of Canada to Alberta and British Columbia show that the fiscal benefits financed by natural resource revenues have attracted those in all income groups. Had western natural resource revenues remained at their 1971 level, migration rates to Alberta and British Columbia would have been lower than they were in 1977, according to the simulations. For example, the rate of migration to Alberta by those in the low-income group is increased by about 13 per cent as a result of the increase in natural resource revenues in the West. The corresponding rate of increase for the middle- and high-income groups is about 10 per cent.

While the estimated impact of the increase in equalization payments from 1971 to 1977 is ambiguous in the case of out-migration from the Atlantic provinces, it is much clearer in the case of in-migration to Alberta and British Columbia. The simulations show that the increase in equalization payments, which to a large extent was the result of a rise in western natural resource revenues, produce a reduction in migration rates to Alberta and British Columbia of between 6 and 16 per cent for the low-income group, and between 2 and 6 per cent for the middle- and high-income groups.

With respect to the role of the changes in the unemployment insurance system, the results indicate that the effect of unemployment insurance in encouraging migration to Alberta and British Columbia outweighs its effect in retarding it. The only exception is that of persons in the middle- and high-income groups who are moving from the Atlantic region or Quebec. This complicates the drawing of easy conclusions concerning the desirability of providing regional variations in the unemployment insurance system. The migration rate for persons in the low-income group moving from Ontario to Alberta increases by about 10 per cent, and for those in the middle- and high-income groups by about 2 per cent, as a result of the regional variations in the operation of the unemployment insurance system that occurred between 1971 and 1977. Generally, the overall effect of unemployment insurance in stimulating migration is greatest for the low-income group across provinces of origin.

Thus if we combine this result with the results for out-migration from the Atlantic provinces, it is evident that the regional variations in the unemployment insurance system have, on balance, retarded out-migration from the Atlantic region to central Canada, while they have tended to encourage outflows from central Canada to Alberta and British Columbia. Moreover, the magnitude of these effects is much greater for the low-income group than for the middle- and high-income groups.

When all three fiscal changes are considered simultaneously, it would appear that the retarding influence of equalization grants is generally outweighed by the effects of unemployment insurance and natural resource revenues in promoting migration to Alberta and British Columbia. The important exceptions are those migrants originating in the Atlantic provinces, especially the higher-income group. The increase in the rate of out-migration from Ontario to Alberta is around 24 per cent for the low-income group and about half that figure for the middle- and high-income groups.

A Comparison of the Public and Private Economic Factors Affecting Interprovincial Migration

To complete the analysis and to provide a basis for comparison, simulations on the quantitative importance of employment income for migration were also undertaken. These simulations indicate how the evolution of regional differences in employment income between 1971 and 1977 may have affected interprovincial migration.[10]

In the case of migration to Alberta and British Columbia, employment income is more important than fiscal structure in explaining recent migration trends. The simulations show that both absolutely and relative to the influence of fiscal structure, employment income variations are quantitatively more important to the middle- and high-income groups than to the low-income group. For example, the simulated change in the rate of migration from Ontario to Alberta that is due to employment income variations alone is about 68 per cent for the middle- and high-income groups and about 24 per cent for the low-income group, while the combined effects of variations in fiscal structure for these groups are approximately 13 per cent and 23 per cent, respectively. Such results reinforce the previous conclusion that fiscal structure generally matters more (in an absolute sense) to lower-income persons.

The simulations for out-migration from the Atlantic region, however, show that for both income groups, fiscal structure is as important – or even more important in certain cases – than employment income in explaining the recent migration patterns for that region.

Thus the impression given by the results as a whole is that fiscal structure is of greater importance relative to employment income in explaining out-migration from the Atlantic provinces than it is in explaining in-migration to Alberta and British Columbia.

Summary Observations

The analysis of the simulations, as well as of the determinants of migration discussed in the previous section, indicates that fiscal structure does influence interprovincial migration decisions and that the effects of specific fiscal variables vary importantly by region. The simulations also show that fiscal structure generally influences low-income persons more than those in the middle- and high-income groups. In view of the paucity of evidence on the nature and extent of fiscally induced migration in the Canadian context, these results represent a substantial addition to our knowledge about the influence of the public sector on migration decisions.

The results do not, in the end, fully resolve the questions related to the regional trade-off between equity and efficiency, which led to the undertaking of further research in this area by the Council. But the results do indicate that these questions are relevant to the issues under consideration, which in itself is of some importance. If decisions to migrate from one province to another were, in fact, not influenced by differences in net fiscal benefits among provinces, it is apparent that they would not be a matter of concern from the viewpoint of efficiency, but only in terms of equity.

The above results and simulations illustrate the central role that efficiency considerations might play in future policy decisions with respect to fiscal structure in Canada. For example, fiscal benefits related to natural resource revenues do increase the odds of migration to the West, especially for low-income persons, while equalization reduces the odds. In light of our discussion on the equity/efficiency trade-off, it can be said that equalization is serving one of its intended purposes – namely, that of retarding migration to the West by those who cannot be as productively employed in the West as elsewhere in the country. Moreover, it is evident that the way in which natural resource revenues are included in the equalization formula can have significant repercussions in terms of equity and efficiency, which should be taken into account in the formulation of policy.

Appendix B

The Calculation of Natural Resource Rents and Their Distribution

The following tables give estimates of some natural resource rents in Canada, by producing province, and show the redistribution of a portion of those rents to other Canadians and to foreigners. For the oil and gas rents, two estimates are provided: low and high. The low estimate for oil is based on the federal import compensation rate at Toronto/Montreal; the high estimate is based on the export charge rate (light and medium oils, and condensate oils). The low estimate for natural gas and liquefied petroleum gases is derived by using 85 per cent of the heat-equivalent price of imported crude oil at Toronto/Montreal; the high estimate is based on the full heat-equivalent price of crude oil.

Table B-1

Natural Resource Revenues[1] Collected in Each Province, by Resource Category, Canada, 1980/81

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
						(Millions of current dollars)						
Forestry	1.7	–	2.8	7.6	46.3	52.8	1.7	4.4	8.5	337.1	–	462.8
Minerals	26.3	–	7.1	5.8	67.6	84.3	27.8	304.3	49.2	80.6	–	652.9
Crown oil	–	–	–	–	–	–	3.1	272.5	2,276.6	50.9	–	2,603.1
Freehold oil	–	–	–	–	–	–	10.1	76.1	55.2	–	–	141.4
Crown gas	–	–	–	–	–	–	–	0.9	1,778.0	238.7	–	2,017.7
Freehold gas	–	–	–	–	–	–	–	–	84.0	–	–	84.0
Sale of Crown leases	–	–	–	–	–	–	–	24.3	740.4	146.3	–	911.0
Other oil and gas revenues	–	0.2	–	–	0.2	1.4	0.5	12.8	97.4	21.0	–	133.5
Total natural resource revenues	27.9	0.2	9.8	13.4	114.1	138.4	43.2	695.2	5,089.3	874.7	–	7,006.4

1 Excluding water power rentals.

SOURCE Department of Finance, "Provincial Fiscal Equalization Tables: Third Estimate, 1980-81."

Table B-2

Low Estimate of Rents on Crude Oil, Natural Gas and LPG, and Hydro-electricity, Not Collected by Producing Province, Canada, 1980

	New-foundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
	(Millions of current dollars)											
Exports of crude oil (rents uncollected because of federal export charges):												
Light, medium, condensates	-	-	-	-	-	-	-	-	0.9	-	-	0.9
Specified heavy, medium (including Wainwright)	-	-	-	-	-	-	2.1	315.3	136.3	-	-	453.8
Lloydminster	-	-	-	-	-	-	-	219.8	8.6	-	-	228.4
Subtotal (exports)	-	-	-	-	-	-	2.1	535.1	145.8	-	-	683.0
Domestic sale of Canadian crude oil	-	-	-	-	-	12.2	71.4	668.3	8,941.4	277.8	20.7	9,991.8
Subtotal, crude oil	-	-	-	-	-	12.2	73.5	1,203.5	9,087.2	277.8	20.7	10,674.9
Domestic sale of natural gas	-	-	-	0.3	-	39.1	-	149.1	4,358.4	436.7	47.4	5,031.0
Domestic sale of gas plant LPG	-	-	-	-	-	-	-	9.4	168.8	13.6	-	191.8
Subtotal, natural gas and LPG	-	-	-	0.3	-	39.1	-	158.5	4,527.2	450.4	47.4	5,222.8
Hydro-electricity	736.7	-	26.4	70.5	1,514.4	758.1	455.8	29.0	6.7	139.7	-	3,737.3
Total (oil, gas, and hydro)	736.7	-	26.4	70.8	1,514.4	809.4	529.3	1,391.0	13,621.1	867.9	68.1	19,635.0

LPG - liquefied petroleum gases.
SOURCE Estimates by the Economic Council of Canada.

Table B-3

High Estimate of Rents on Crude Oil, Natural Gas and LPG, and Hydro-electricity, Not Collected by Producing Province, Canada, 1980

	New-foundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
						(Millions of current dollars)						
Exports of crude oil (rents uncollected because of federal export charges)	–	–	–	–	–	–	2.1	535.1	145.8	–	–	683.0
Domestic sale of Canadian crude oil	–	–	–	–	–	15.5	90.9	853.9	11,378.7	353.9	26.3	12,719.2
Subtotal, crude oil	–	–	–	–	–	15.5	93.1	1,389.0	11,524.5	353.9	26.3	13,402.3
Domestic sale of natural gas	–	–	–	0.3	–	51.5	–	196.3	5,736.4	575.1	62.4	6,622.0
Domestic sale of gas plant LPG	–	–	–	–	–	–	–	12.3	221.9	17.9	–	252.2
Subtotal, natural gas and LPG	–	–	–	0.3	–	51.5	–	208.6	5,958.3	593.0	62.4	6,874.2
Hydro-electricity	736.7	–	26.4	70.5	1,514.4	758.1	455.8	29.0	6.7	139.7	–	3,737.3
Total (oil, gas, and hydro)	736.7	–	26.4	70.8	1,514.4	825.1	548.9	1,626.6	17,489.5	1,086.6	88.7	24,013.8

LPG – liquefied petroleum gases.
SOURCE Estimates by the Economic Council of Canada.

Table B-4
Low and High Estimates of Total and Per Capita Natural Resource Rents, Canada, by Province, 1980

	New-foundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
						(Thousands of persons)						
Population	579.9	124.3	852.5	707.1	6,303.4	8,570.4	1,028.3	969.2	2,078.5	2,636.5	64.4	23,914.5
						(Millions of current dollars)						
Low estimate												
Total rents (sum of totals in Tables B-1 and B-2)	764.7	0.2	36.3	84.1	1,628.5	947.8	572.5	2,086.2	18,710.4	1,742.6	68.0	26,641.4
						(Current dollars)						
Total rents per capita	1,318.6	1.9	42.5	119.0	258.4	110.6	556.7	2,152.5	9,001.9	661.0	1,056.6	1,114.0
						(Canada = 100)						
Index of rents per capita	118.4	0.2	3.8	10.7	23.2	9.9	50.0	193.2	808.0	59.3	94.8	100.0
						(Millions of current dollars)						
High estimate												
Total rents (sum of totals in Tables B-1 and B-3)	764.7	0.2	36.3	84.2	1,628.5	963.5	592.0	2,322.0	22,578.8	1,961.2	88.8	31,020.2
						(Current dollars)						
Total rents per capita	1,318.6	1.9	42.5	119.1	258.4	112.4	575.7	2,395.7	10,863.0	743.9	1,378.4	1,297.1
						(Canada = 100)						
Index of rents per capita	101.7	0.1	3.3	9.2	19.9	8.7	44.4	184.7	837.5	57.3	106.3	100.0

SOURCE Estimates by the Economic Council of Canada.

Table B-5

Low and High Estimates of Net Redistribution of Crude Oil Rents to Other Provinces, Canada, 1980

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
	(Millions of current dollars)											
Subsidy on refined petroleum products (at Toronto/Montreal import compensation rate)	341.7	66.7	763.8	732.4	3,781.7	4,411.6	448.2	534.2	1,299.3	1,401.7	74.1	13,855.5
Financing of subsidy:												
Rents uncollected by producing provinces (from Table B-2 - low estimate)	-	-	-	-	-	12.2	73.5	1,203.5	9,087.2	277.8	20.7	10,674.9
Rents uncollected by producing provinces (from Table B-3 - high estimate)	-	-	-	-	-	15.5	93.1	1,389.0	11,524.5	353.8	26.3	13,402.3
Special federal tax on private consumption of motor gasoline	8.5	2.6	17.0	14.7	117.9	173.8	18.7	18.6	53.2	53.4	1.0	479.5
Syncrude levy	22.4	4.3	49.1	47.2	241.4	283.4	29.0	35.2	86.1	91.0	5.0	894.0
Additional petroleum compensation charge under the NEP	2.1	0.4	5.3	5.3	27.4	29.9	3.0	3.5	8.8	9.5	0.4	95.6
Excess or deficiency (-) of subsidy over financing[1]												
Low estimate	15.6	3.9	43.2	29.3	367.4	736.6	58.1	60.1	195.2	195.4	6.8	1,711.6
High estimate	-9.3	-2.3	-25.6	-17.4	-218.1	-437.2	-34.5	-35.6	-115.9	-116.0	-4.1	-1,015.8
Net redistribution[2]												
Low estimate	293.0	55.5	649.3	635.9	3,027.6	3,175.8	265.8	-786.6	-8,131.3	774.6	40.2	-
High estimate	318.0	61.7	718.1	682.6	3,613.1	4,346.2	338.9	-876.5	-10,257.5	1,009.9	45.4	-

NEP - National Energy Program.

1 The excess or deficiency (-) for Canada is the difference between the subsidy and the sum of: rents not collected, the special federal tax on gasoline, the Syncrude levy, and additional petroleum compensation charge. This is distributed among provinces in proportion to their contribution to federal revenue.

2 Net redistribution is the difference between the subsidy and the amount of subsidy financed.

SOURCE Estimates by the Economic Council of Canada.

Table B-6

Low and High Estimates of Net Redistribution of Natural Gas and Gas Plant LPG Rents to Other Provinces, Canada, 1980

	New-foundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
						(Millions of current dollars)						
Subsidy on gas and LPG:												
At 85% of heat-equivalent price of crude oil landed at Toronto/Montreal - low estimate	-	-	-	0.3	307.1	2,085.5	240.1	391.9	1,590.9	510.9	25.0	5,151.7
At 100% of heat-equivalent price of crude oil landed at Toronto/Montreal - high estimate	-	-	-	0.4	404.2	2,746.4	316.3	516.1	2,094.4	672.9	32.7	6,783.5
Financing of subsidy:												
Rents uncollected by producing provinces (from Table B-2 - low estimate)	-	-	-	0.3	-	39.1	-	158.5	4,527.2	450.4	47.4	5,222.8
Rents uncollected by producing provinces (from Table B-3 - high estimate)	-	-	-	0.3	-	51.5	-	208.6	5,958.3	593.0	62.4	6,874.2
Federal sales tax on domestic consumption under the NEP	-	-	-	-	6.1	39.7	5.0	7.0	28.4	10.5	-	96.9
Deficiency (-) of subsidy over financing[1]												
Low estimate	-1.5	-0.4	-4.2	-2.9	-36.1	-72.3	-5.7	-5.9	-19.2	-19.2	-0.7	-168.0
High estimate	-1.7	-0.4	-4.7	-3.2	-40.3	-80.7	-6.4	-6.6	-21.4	-21.4	-0.7	-187.6
Net redistribution[2]												
Low estimate	1.5	0.4	4.2	2.9	337.0	2,078.9	240.9	232.3	-2,945.6	69.2	-21.8	-
High estimate	1.7	0.4	4.7	3.3	438.4	2,735.9	317.7	307.1	-3,871.0	90.8	-29.0	-

LPG - liquefied petroleum gases; NEP - National Energy Program.

1 The deficiency (-) for Canada is the difference between the subsidy and the sum of rents not collected and the federal sales tax on domestic consumption. This is distributed among provinces in proportion to their contribution to federal revenue.

2 Net redistribution is the difference between the subsidy and the amount of subsidy financed.

SOURCE Estimates by the Economic Council of Canada.

Table B-7

Estimates of Net Redistribution of Hydro-electricity Rents to Other Provinces, Canada, 1980

	New-foundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
						(Millions of current dollars)						
Rents gained by Canadian users	133.6	3.4	30.2	132.7	1,674.1	827.9	323.8	59.4	7.1	133.0	-	3,325.2
Rents on production (from Table B-2)	736.7	-	26.4	70.5	1,514.4	758.1	455.8	29.0	6.7	139.7	-	3,737.3
Rents lost on exports	-73.5	-	-0.1	-9.1	-175.0	-92.4	-55.6	-0.1	-	-6.3	-	-412.1
Rents uncollected from Canadian users	663.2	-	26.3	61.4	1,339.4	665.7	400.2	28.9	6.7	133.4	-	3,325.2
Net redistribution	-529.6	3.4	3.9	71.3	334.7	162.2	-76.4	30.5	0.4	-0.4	-	-

SOURCE Estimates by the Economic Council of Canada.

Table B-8

Estimates of Net Natural Resource Revenues Redistributed to Other Provinces through Equalization Payments, Canada, 1980/81

	New-foundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
	(Millions of current dollars)											
Increase in payments because of inclusion of natural resource revenues in equal-ization formula	36.7	17.4	109.2	71.4	717.2	-	118.1	-68.5	-	-	-	1,001.6
Amount of increase financed	9.2	2.3	25.3	17.1	215.0	431.0	34.0	35.1	114.2	114.3	4.0	1,001.6
Net redistribution	27.6	15.2	83.9	54.2	502.2	-431.0	84.1	-103.6	-114.2	-114.3	-4.0	-

SOURCE Estimates by the Economic Council of Canada, based on data from Department of Finance, "Provincial Fiscal Equalization Tables: Third Estimate, 1980-81."

Table B-9

Low and High Estimates of Total and Per Capita Net Distribution of Natural Resource Rents, by Province, Canada, 1980

	New-foundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada
						(Millions of current dollars)						
Low estimate												
Redistribution of rents to other provinces:												
Total[1]	-207.4	74.5	741.3	764.4	4,201.5	4,985.9	514.4	-627.4	-11,190.6	729.1	14.4	-
						(Current dollars)						
Per capita	-357.7	599.1	869.6	1,081.0	666.5	581.8	500.3	-647.3	-5,384.0	276.5	224.0	-
Net distributed rents						(Millions of current dollars)						
Total[2]	483.7	74.7	777.5	839.4	5,655.0	5,841.3	1,031.3	1,458.7	7,519.8	2,465.4	82.5	26,229.2
						(Current dollars)						
Per capita	834.1	601.0	912.0	1,187.1	897.1	681.6	1,003.0	1,505.1	3,617.9	935.1	1,280.6	1,096.8
						(Canada = 100)						
Index of rents per capita	76.0	54.8	83.2	108.2	81.8	62.1	91.4	137.2	329.9	85.3	116.8	100.0
						(Millions of current dollars)						
High estimate												
Redistribution of rents to other provinces:												
Total[1]	-182.3	80.7	810.6	811.4	4,888.4	6,813.3	664.3	-642.5	-14,242.4	986.0	12.4	-
						(Current dollars)						
Per capita	-314.4	649.1	950.9	1,147.5	775.5	795.0	646.1	-663.0	-6,852.2	374.0	193.0	-
Net distributed rents						(Millions of current dollars)						
Total[2]	508.8	80.9	846.8	886.5	6,341.8	7,684.4	1,200.8	1,679.3	8,336.5	2,941.0	101.2	30,608.0
						(Current dollars)						
Per capita	877.4	651.0	993.3	1,253.7	1,006.1	896.6	1,167.7	1,732.7	4,010.8	1,115.5	1,571.4	1,279.9
						(Canada = 100)						
Index of rents per capita	68.6	50.9	77.6	98.0	78.6	70.1	91.2	135.4	313.4	87.2	122.8	100.0

1 Equal to the sum of "net redistribution" (last line, Tables B-5 to B-8, inclusive); a negative number indicates net redistribution to other provinces.
2 Equal to total rents (Table B-4) plus rents redistributed from or to (-) others, which is the sum of total redistribution to other provinces (above) and hydro rents redistributed to foreigners ("hydro rents lost on exports," line 3, Table B-7).
SOURCE Estimates by the Economic Council of Canada.

Appendix C

Specific-Purpose Grants for Health Insurance and Postsecondary Education: From Cost Sharing to Block Funding

This appendix describes specific-purpose grants for hospital and medical insurance and postsecondary education both before and after the introduction of the Established Programs Financing system in 1977.

The Programs prior to EPF

Hospital Insurance, 1957

Specific-purpose grants for health care began in 1919 with a program to assist provinces in the control and prevention of venereal disease. At the Dominion-Provincial Conference on Reconstruction in 1945, the federal government proposed a national health insurance scheme, but the provinces argued that limited facilities and lack of trained manpower would make this impossible. As a result, National Health Grants were instituted in 1948 to help provide the training and facilities required. By the early 1950s, the three western provinces and Newfoundland were providing prepaid hospital care to their citizens, and the federal government began developing policies to make similar services available nationally.

The Hospital Insurance and Diagnostic Services Act was passed unanimously by the House of Commons and the Senate in April 1957 and was proclaimed law effective May 1, 1957. Under the Act, the federal government paid each province an amount, per insured person, equal to the sum of: (a) 25 per cent of the national per capita cost of approved in-patient hospital services, and (b) 25 per cent of the provincial per capita cost of approved in-patient hospital services, less any deterrent charges levied. Coverage of out-patient hospital services was optional, and cost was shared in the same proportion as for in-patient services.

The Act required the provinces to sign an agreement with the federal government, stating that they:

> shall covenant and agree
>
> (a) to make insured services available to all residents of the province upon uniform terms and conditions;
>
> (b) . . . ensure that adequate standards are maintained;
>
> (c) . . . maintain adequate records and accounts . . .;
>
> (d) . . . provide insured services in a manner that does not impede or preclude, either directly or indirectly, whether by charges or otherwise, reasonable access to insured services by persons entitled thereto and eligible therefor.

The four provinces that were already operating hospital insurance plans in 1957 – Newfoundland, Saskatchewan, Alberta, and British Columbia – signed agreements immediately. By 1961, all provinces and territories had a hospital insurance plan.

Medical Care, 1968

The Medical Care Plan was implemented in 1968 to encourage all provinces to establish universally available prepaid medical care plans. Before its introduction, only one province had such a plan. The basis for the Medical Care Plan was the recommendations of the Royal Commission on Health Services, chaired by the Honourable Emmett Hall, which was appointed in 1961 and submitted its report in 1964.

The Medical Care Act was passed by the House of Commons on December 8, 1966, and was implemented on July 1, 1968. Under this Act, the federal government paid each province an amount equal to 50 per cent of the per capita cost of insured services in all provinces, multiplied by the average number of insured persons in the province.

The Act is much less detailed than the previous hospital insurance legislation. It specifies that in order for a province to receive federal funding, it must ensure that:

– there is comprehensive coverage of all medically required services, cosmetic surgery being the main exclusion;

– coverage is universally available to all residents of that province under uniform terms and conditions (plans were expected to enrol 95 per cent or more of the population);

– the plan is administered in such a way that there is no financial impediment or preclusion to any persons from receiving necessary care;

– benefits continue when the insured person travels between provinces or is temporarily abroad, and the province must cover former residents for three months until they have been accepted by another provincial plan;

– the plan is administered by a public agency on a non-profit basis.

Saskatchewan has had a universal plan since 1961. Alberta, British Columbia, and Ontario had partial medical plans, which were quickly expanded. Within two and one-half years from the introduction of the Act, all provinces had qualifying plans.

Postsecondary Education, 1967

In 1952, the federal government introduced a system of equal per capita grants for postsecondary education. To avoid objections of federal interference in an area of provincial jurisdiction, the Association of Universities and Colleges of Canada was used as a channel for these funds. Quebec objected, however, and threatened to reduce provincial transfers if federal assistance was accepted. No solution was fou. .l until 1959, when the federal government agreed to reduce corporate income tax in Quebec by

1 per cent of taxable income if Quebec made grants equal to the federal grants in other provinces. A cash adjustment balanced the revenue forgone and the cost of grants.

In 1967, the federal government began paying to each province 50 per cent of the operating costs of postsecondary education institutions within the province, or $15 per capita (escalated annually by the rate of increase of postsecondary operating costs in all provinces), whichever was higher. Three provinces – New Brunswick, Prince Edward Island, and Newfoundland – received the per capita payment. Part of this transfer was in the form of a tax transfer; that is, federal personal and corporate taxes were reduced to create room for provincial tax increases. The balance was paid in cash, either through equalization of the tax transfer or through the Secretary of State's budget. To avoid jurisdictional debate, the payment was based on half the operating costs of institutions. It made no reference to provincial programs or financing of the institutions. In 1972, the federal government limited the annual rate of increase in transfers to 15 per cent.

The System since EPF

Established Programs Financing, 1977

Federal contributions for hospital insurance, medical insurance, and postsecondary education are no longer related to actual operating costs and have not been since the introduction of EPF on April 1, 1977. Under the terms of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, each province receives a transfer in the form of federal personal and corporate income tax reductions and cash contributions, the cash component having been designed to replace 50 per cent of the federal contribution to the three programs under cost sharing. The basic cash contribution to hospital and medical insurance is subject to the general conditions that were attached to the pre-1977 cost-sharing arrangements concerning comprehensiveness, universality, accessibility, portability, and public administration. The more detailed conditions and reporting requirements have been dropped.

The components of the new arrangement in more detail are as follows:

Federal income tax reduction – Each province receives "tax room" consisting of federal reductions equal to 1 per cent of the corporate taxable income and 13.5 per cent of federal basic personal income tax. These tax transfers are automatically equalized under the general equalization formula in the Act.

Basic cash contribution – Each province receives a cash payment based on 50 per cent of the average per capita federal contribution to the three programs in the base year 1975/76, plus $7.63 per capita. The amount of the grant is increased in accordance with the growth of provincial population and a moving average of GNP growth.

Transitional adjustment payment – As long as the value of the "equalized" federal income tax transfer falls short of the value of the basic cash contribution, the province receives the difference in the form of a cash payment. This assists provinces with below-average tax yields and protects them against an initial low tax elasticity.

Leveling payment – Prior to the new arrangements, there were substantial differences in the federal per capita transfers in each province, particularly for postsecondary education. To smooth the adjustment to equal per capita cash transfers, contributions to the high-cost provinces were "leveled down" over a period of five years, while the contributions to the low-cost provinces were "leveled up" over three years.

The new arrangements include an Extended Health Care Grant of $20 per capita, indexed to the rate of growth of GNP, to cover the costs of nursing home intermediate care, adult residential care, home care, and ambulatory health care. A substantial proportion of the Extended Health Care Grant has been offset by a reduction in payments under the Canada Assistance Plan.

Appendix D

Statistical Data Pertaining to Chapter 7

Table D-1

Indexes of Growth in Public and Total Health Expenditures as a Proportion of Gross Domestic Product,[1] Selected Countries, 1962 to 1974[2]

	Expenditures	
	Public	Total
	(1962 = 100)	
Canada	203	130
United States	254	148
Australia	153	128
France	172	147
Sweden	185	155
Netherlands	185	164
New Zealand	127	126
United Kingdom	137	130
Switzerland	173	132
Finland	212	145
Unweighted average (10 countries)	174	141

1 Estimates are based on GDP trends at current prices.
2 Or nearest year for which data are available.
SOURCE Estimates by the Economic Council of Canada, based on the Organisation for Economic Co-operation and Development, *Public Expenditures on Health*, Studies in Resource Allocation, Series No. 4 (Paris: OECD, July 1977).

Table D-2

Contribution of Hospital Admission Rates and Length of Hospital Stay to Provincial Variations in Patient-Days per Capita, General and Allied Public Hospitals, Canada, 1961-77

	Contribution[1]			
	1961-65	1966-70	1971-75	1976-77
	(Percentage points)			
Hospital admission rates:				
Newfoundland	-26	-10	-4	5
Prince Edward Island	-5	2	16	38
Nova Scotia	-8	-1	-2	4
New Brunswick	2	4	10	9
Quebec	-8	-10	-21	-31
Ontario	-4	-8	1	3
Manitoba	11	12	5	2
Saskatchewan	32	32	35	33
Alberta	28	36	32	26
British Columbia	-	4	-1	-
Length of hospital stay:				
Newfoundland	2	9	1	-22
Prince Edward Island	-3	-9	-28	-57
Nova Scotia	-3	-7	-7	-29
New Brunswick	-1	-1	-7	-18
Quebec	2	6	18	60
Ontario	8	9	-3	-14
Manitoba	-10	-16	-11	-17
Saskatchewan	-3	-15	-23	-33
Alberta	-7	-4	6	-22
British Columbia	-13	-21	-11	-13

1 The percentage point estimates in this table show by how much patient-days per capita vary among provinces because of provincial variations in hospital admission rates and length of stay. All of these estimates have been standardized for provincial variations in age distribution.
SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

Table D-3

Contribution of Nursing, Diagnostic and Therapeutic Services, Education, and Administrative Support Services to Provincial Variations in Labour Hours per Patient-Day and in Costs per Patient-Day, Canada, 1961-78

		Contribution				
		Nursing	Diagnostic and therapeutic services	Education	Administrative support	Deviation from national total[1]
		(Percentage points)				(Per cent)
Newfoundland	1961-65	-13	-	3	-1	-11
	1966-70	-11	-1	2	-	-10
	1971-75	1	1	4	-	6
	1976-78	9	7	12	7	35
Prince Edward Island	1961-65	-24	-2	2	3	-21
	1966-70	-23	-4	1	1	-25
	1971-75	-2	-8	1	-1	-10
	1976-78	-	-9	3	3	-3
Nova Scotia	1961-65	-2	-	2	1	1
	1966-70	-2	-	2	-	-
	1971-75	1	1	2	-1	3
	1976-78	11	9	2	4	26
New Brunswick	1961-65	2	-3	1	4	4
	1966-70	-	-6	1	2	-3
	1971-75	1	-8	2	2	-3
	1976-78	4	-8	-	5	1
Quebec	1961-65	-1	3	1	3	6
	1966-70	3	4	1	3	11
	1971-75	3	5	-3	3	8
	1976-78	-3	2	-3	-	-4
Ontario	1961-65	4	-1	-1	-1	1
	1966-70	2	-	-1	-	1
	1971-75	-	1	-	-	1
	1976-78	2	-	-1	-	1
Manitoba	1961-65	1	-	-	-1	-
	1966-70	-	-1	1	-2	-2
	1971-75	3	-2	2	-1	2
	1976-78	5	-2	3	1	7
Saskatchewan	1961-65	-14	-	-	-	-14
	1966-70	-11	-2	-1	-1	-15
	1971-75	-4	-5	-1	-2	-12
	1976-78	-4	-6	-1	-2	-13
Alberta	1961-65	-2	-2	-1	-3	-8
	1966-70	-3	-4	-1	-3	-11
	1971-75	-5	-5	1	-4	-13
	1976-78	1	-3	2	-1	-1
British Columbia	1961-65	-	-1	-2	-3	-6
	1966-70	-2	-2	-1	-2	-7
	1971-75	-3	-5	1	-2	-9
	1976-78	-1	-5	1	-2	-7

1 The differences between the provinces and Canada correspond to those in column 1 of Table 7-10.
SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

Table D-4

Contribution of Nursing, Diagnostic and Therapeutic Services, Education, and Administrative Support Services to Provincial Variations in Wage Rates per Hour and in Costs per Patient-Day, Canada, 1961-78

		Contribution				
		Nursing	Diagnostic and therapeutic services	Education	Administrative support	Deviation from national total[1]
		(Percentage points)				(Per cent)
Newfoundland	1961-65	1	1	-	-3	-1
	1966-70	-	-2	-1	-5	-8
	1971-75	-7	-1	-2	-3	-13
	1976-78	-7	-2	-8	-3	-20
Prince Edward Island	1961-65	11	-4	-3	-11	-7
	1966-70	11	-3	-3	-9	-4
	1971-75	-7	-1	-2	-5	-15
	1976-78	-9	-2	-3	-6	-20
Nova Scotia	1961-65	-3	-1	-1	-6	-11
	1966-70	-4	-1	-2	-5	-12
	1971-75	-5	-1	-1	-3	-10
	1976-78	-9	-2	-1	-6	-18
New Brunswick	1961-65	-3	-1	-1	-6	-11
	1966-70	-5	1	-2	-5	-11
	1971-75	-4	2	-2	-3	-7
	1976-78	-6	1	-1	-3	-9
Quebec	1961-65	-	1	1	1	3
	1966-70	3	1	1	3	8
	1971-75	1	-	3	-	4
	1976-78	-	-1	3	1	3
Ontario	1961-65	-1	-	1	1	1
	1966-70	-1	-	1	-	-
	1971-75	1	-	1	-	2
	1976-78	2	1	1	-	4
Manitoba	1961-65	-2	-1	-1	-2	-6
	1966-70	-4	-2	-1	-3	-10
	1971-75	-4	-3	-1	-2	-10
	1976-78	-4	-2	-2	-3	-11
Saskatchewan	1961-65	7	-3	-2	-4	-2
	1966-70	2	-3	-1	-4	-6
	1971-75	-4	-2	-1	-3	-10
	1976-78	-3	-1	-2	-2	-8
Alberta	1961-65	-1	-1	-1	-1	-4
	1966-70	-2	-1	-2	-1	-6
	1971-75	-2	-1	-2	-	-5
	1976-78	-1	-	-2	-	-3
British Columbia	1961-65	3	-	-	3	6
	1966-70	3	1	-1	2	5
	1971-75	6	2	-2	4	10
	1976-78	3	3	-1	2	7

1 The differences between the provinces and Canada correspond to those in column 2 of Table 7-10.

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

Table D-5

Contribution of Nursing, Diagnostic and Therapeutic Services, Education, and Administrative Support Services to Provincial Variations in Other Operating Expenditures and in Costs per Patient-Day, Canada, 1961-78

		Contribution				
		Nursing	Diagnostic and therapeutic services	Education	Administrative support; medical, surgical, and drug expenses	Deviation from national total[1]
		(Percentage points)				(Per cent)
Newfoundland	1961-65	-	1	-	12	13
	1966-70	-	-	-	6	6
	1971-75	-	-	-	5	5
	1976-78	-	1	-	14	15
Prince Edward Island	1961-65	-	-	-	-4	-4
	1966-70	-	-	-	-6	-6
	1971-75	-	-	-	-7	-7
	1976-78	-	1	1	-3	-1
Nova Scotia	1961-65	-	3	-	2	5
	1966-70	-	3	-	1	4
	1971-75	-	3	-	-	3
	1976-78	-	2	-	8	10
New Brunswick	1961-65	-	3	-	1	4
	1966-70	-	1	-	-2	-1
	1971-75	-	3	-	-3	-
	1976-78	-	4	-	1	5
Quebec	1961-65	-	1	-	2	3
	1966-70	-	1	-	1	2
	1971-75	-	1	-	3	4
	1976-78	-	-	-	-1	-1
Ontario	1961-65	-	-	-	-	-
	1966-70	-	-	-	1	1
	1971-75	-	-	-	1	1
	1976-78	-	-	-	1	1
Manitoba	1961-65	-	-1	-	-2	-3
	1966-70	-	-	-	-2	-2
	1971-75	-	1	-	-1	-
	1976-78	-	2	-	-1	1
Saskatchewan	1961-65	-	-1	-	-5	-6
	1966-70	-	-1	-	-5	-6
	1971-75	1	-2	-	-6	-7
	1976-78	1	-1	-	-3	-3
Alberta	1961-65	-	-2	-	-3	-5
	1966-70	-	-2	-	-3	-5
	1971-75	-	-2	-	-5	-7
	1976-78	-	-	-	-	-
British Columbia	1961-65	-	-2	-	-1	-3
	1966-70	-	-1	-	-2	-3
	1971-75	-	-1	-1	-4	-6
	1976-78	-	-1	-	-3	-4

1 The differences between the provinces and Canada correspond to those in column 3 of Table 7-10.

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

Table D-6

Contribution of Patient-Days per Capita and Cost per Patient-Day to Provincial Variations in Operating Expenditures, General and Allied Public Hospitals, Including and Excluding Mental Institutions, Canada, 1976-78

	Contribution		Deviation from national average
	Patient-days per capita	Cost per patient-day	
	(Percentage points)		(Per cent)
Excluding mental institutions			
Newfoundland	-34	25	-9
Prince Edward Island	-12	-22	-34
Nova Scotia	-24	16	-8
New Brunswick	-9	-3	-12
Quebec	19	-2	17
Ontario	-9	5	-4
Manitoba	-8	-3	-11
Saskatchewan	13	-25	-12
Alberta	-	-5	-5
British Columbia	-3	-5	-8
Including mental institutions			
Newfoundland	-31	24	-7
Prince Edward Island	6	-33	-27
Nova Scotia	-17	12	-5
New Brunswick	1	-10	-9
Quebec	9	4	13
Ontario	-6	4	-2
Manitoba	-	-9	-9
Saskatchewan	10	-24	-14
Alberta	3	-8	-5
British Columbia	1	-8	-7

SOURCE Estimates by the Economic Council of Canada, based on unpublished data from Statistics Canada.

Table D-7

Provincial Expenditures for Extended Health Care Facilities per Resident-Day, by Selected Users, Canada, 1977/78[1]

	Relationship to national average (Canada = 100)					
	The aged	Unmarried mothers	Mentally handicapped	Alcoholics; drug addicts	Delinquents	All users
			(Per cent)			
Newfoundland	127	..	100	..	67	105
Prince Edward Island	118	..	130	145	..	101
Nova Scotia	96	69	91	45	54	87
New Brunswick	111	..	101	..	..	98
Quebec	112	228	163	275	167	150
Ontario	100	50	94	70	40	92
Manitoba	121	48	72	126	55	96
Saskatchewan	94	74	86	122	63	82
Alberta	79	..	52	61	65	66
British Columbia	76	68	118	48	54	78
			(Dollars)			
Canada	22.80	32.70	34.20	26.20	79.40	28.60

1 The estimates in this table are not necessarily representative of the actual expenditures per resident-day because the survey response pertaining to extended health care facilities was incomplete.

SOURCE Based on estimates from Statistics Canada, *Selected Tables from Annual Return of Special Care Facilities, 1977-78*, Health Division, August 1980, Table 41.

Table D-8

Provincial Expenditures on Physicians' Services per Capita, Canada, Selected Years, 1960-79

	1960	1965	1970	1975	1979[1]
	(Dollars)				
Newfoundland	8.89	11.99	29.38	45.32	68.58
Prince Edward Island	13.16	16.91	27.56	54.14	81.98
Nova Scotia	15.95	20.47	42.62	74.62	101.20
New Brunswick	13.42	17.82	29.57	54.43	69.98
Quebec	15.06	22.84	36.00	81.76	109.73
Ontario	23.18	33.08	59.29	91.93	130.36
Manitoba	21.86	28.60	55.78	70.17	108.63
Saskatchewan	19.90	27.78	40.56	64.28	94.50
Alberta	20.64	26.57	54.77	86.11	120.19
British Columbia	28.26	33.92	58.10	98.58	150.65
Canada	19.82	27.70	48.81	83.62	119.15

1 Data for 1979 are preliminary.
SOURCE Data from Health and Welfare Canada.

Table D-9

Contribution of Specialization to Provincial Variations in Output per Full-Time Physician Equivalent, Canada, 1974-76

	Contribution		Deviation from national average[1]
	Specialization	Output within specialty	
	(Percentage points)		(Per cent)
Newfoundland	-	13	13
Prince Edward Island	-2	-	-2
Nova Scotia	-1	-5	-6
New Brunswick	-	2	2
Quebec	1	5	6
Ontario	-	1	1
Manitoba	-	-8	-8
Saskatchewan	-2	3	1
Alberta	-	-5	-5
British Columbia	-	-10	-10

1 Positive values denote above-average output in services per physician; negative values imply below-average output per physician.
SOURCE L. Auer and J. Menic, "Provincial Variations in the Productivity of Physicians in Canada, 1974-76," Economic Council of Canada, Discussion Paper 205, September 1981.

Table D-10

Comparison of Physicians' Services with Physicians' Incomes,[1] Canada, by Province, 1974-76

	Difference between physicians' services and incomes			
	Gross payments	Professional earnings		Net income from all sources
		Gross	Net	
	(Percentage points)			
Newfoundland	-12	-14	-7	-6
Prince Edward Island	3	-4	-9	-11
Nova Scotia	5	3	9	11
New Brunswick	-8	-11	-5	-6
Quebec	-9	-11	-1	2
Ontario	-1	-	-2	-2
Manitoba	2	16	1	4
Saskatchewan	-5	-4	-9	-7
Alberta	12	18	6	6
British Columbia	20	10	5	1

1 Negative values in this table imply that physicians of a particular province are paid less than the volume of services would warant; conversely, positive values imply that they are paid more than the volume of services would warrant. *Gross payment* per physician is based on average provincial fee-for-service payments. In concept, it comes fairly close to *gross professional earnings*; but the latter covers a broader range of activities - namely, payments for uninsured services, payments to physicians who "opted out," and wages and salaries incidental to practice. *Net professional earnings* exclude all expenses of practice; *net income from all sources* excludes all expenses of practice but includes income from all other sources.
SOURCE Data from Health and Welfare Canada.

Table D-11

Relative Taxable Incomes of Selected Professionals, Canada, by Province, Selected Years, 1961, 1971, and 1978

		Relationship to average for the four professions (i.e. 100)			
		Engineers and architects	Lawyers	Dentists	Physicians
		(Per cent)			
Newfoundland	1961	124	100	76	100
	1971	60	102	99	139
	1978	78	97	99	126
Prince Edward Island	1961	100	94	90	116
	1971	87	107	68	138
	1978	..	..	..	..
Nova Scotia	1961	117	87	87	110
	1971	51	97	98	154
	1978	62	89	109	141
New Brunswick	1961	127	68	84	120
	1971	56	88	93	164
	1978	48	85	128	139
Quebec	1961	118	112	60	110
	1971	92	89	71	147
	1978	87	93	96	124
Ontario	1961	86	116	83	115
	1971	71	103	90	136
	1978	65	103	111	122
Manitoba	1961	161	75	67	96
	1971	78	87	96	139
	1978	48	122	107	122
Saskatchewan	1961	129	73	92	106
	1971	81	81	100	138
	1978	78	108	103	110
Alberta	1961	86	98	95	121
	1971	65	92	100	143
	1978	85	111	96	108
British Columbia	1961	80	92	102	127
	1971	65	104	108	123
	1978	77	92	107	123
Canada	1961	98	105	83	114
	1971	75	97	90	138
	1978	75	99	104	121

SOURCE Estimates by the Economic Council of Canada, based on data from Revenue Canada.

Notes

CHAPTER 1

1 *Report of the Royal Commission on Dominion-Provincial Relations* [The Rowell-Sirois Commission], 3 Books (Ottawa: King's Printer, 1940).

2 The Honourable Allan J. MacEachen [Deputy Prime Minister and Minister of Finance], *Federal-Provincial Fiscal Arrangements in the Eighties*, a submission to the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements (Ottawa: Department of Finance, April 1981).

3 Calculations were based upon a comparison of the estimated federal deficit in 1981 under the base case with the federal deficit at "potential" under the "smooth productivity growth" scenario. Both estimates were supplied by the CANDIDE Model 2.0 for the Economic Council's Eighteenth Annual Review.

4 Department of Finance, *Economic Review* (Ottawa: Supply and Services Canada, April 1980), Table 11-2.

5 According to Economic Council of Canada calculations based upon projections from CANDIDE Model 2.0.

CHAPTER 2

1 In 1980/81, equalization payments constituted 18 and 10 per cent of the gross general revenues of the provinces of Manitoba and Quebec, respectively.

2 The Rowell-Sirois Commission report, Book II.

3 The Honourable Mitchell Sharp [then Minister of Finance], statement of September 14, 1966, in the *Report of the Federal-Provincial Tax Structure Committee* (Ottawa: Queen's Printer, 1966), p. 14.

4 Mathematically, this result is derived as follows. In Table 2-1 we have added "own-source revenues" to "equalization payments" to arrive at our revenue capacity. On the other hand, in Table 2-3 we have added "own-source revenues" plus "federal tax contributions" to "equalization payments minus federal tax contributions" in order to arrive at our revenue capacity. In the latter example, of course, the negative and positive values for "tax contribution" cancel out, so that the *end* result of the two approaches is identical.

CHAPTER 3

1 The Council commissioned a special study aimed at undertaking a fundamental reappraisal of the rationale of the Equalization Program to provide the basis for considering possible means of improving its design and structure. The first three sections of this chapter consist of a summarized view of research by Robin Boadway and Frank Flatters, in "The Economics of Equalization Payments," a study prepared for the Economic Council of Canada (forthcoming).

2 Capital being highly mobile and therefore less subject to large interprovincial differences in net fiscal benefits than labour, we thought it more appropriate to confine the discussion on efficiency and equalization in the text to labour.

3 The same qualifications concerning heritage funds and hydro rents that were discussed above in relation to equity issues apply to this discussion of efficiency.

4 See, for instance, J. F. Helliwell and A. R. Scott, *Canada in Fiscal Conflict: Resources and the West* (Vancouver: Pemberton Securities Ltd., 1981).

5 There are many examples of such "two-tier" reform proposals. For a description of how a two-tier program would work, see T. J. Courchene and G. H. Copplestone, "Alternative Equalization Programs: Two-Tier Systems," in *Fiscal Dimensions of Canadian Federalism*, ed. R. M. Bird (Toronto: Canadian Tax Foundation, 1980).

CHAPTER 4

1 David Ricardo, *The Principles of Political Economy and Taxation*, reprint (Homewood, Ill.: Irwin, 1963).

2 Joan Robinson, *The Economics of Imperfect Competition*, 2nd edition (New York: St. Martin's Press, 1969), p. 102. This is a broad definition of rent, which encompasses unearned income that arises from such factors as monopoly, tariffs, and unique skills and can accrue to capital, labour, and entrepreneurship.

3 Lawrence Copithorne, *Natural Resources and Regional Disparities*, Economic Council of Canada (Ottawa: Supply and Services Canada, 1979).

4 Ideally, the rent on current production received by provincial governments in the form of revenues from the sale of Crown leases should be derived on the

basis of the revenues received in this form over a number of years in the past.

5 While some attempt was made to estimate the amount of rent accruing to producers of oil and gas, it became apparent that substantial analytical effort and data, in addition to that publicly available, would be required to provide such an estimate with any acceptable degree of accuracy. It should be noted, however, that the gross liability of producers as a result of the federal Petroleum and Gas Revenue Tax, and the Incremental Oil Revenue Tax, which was presumably designed to capture some of the rent accruing to producers, is estimated at about $1.2 billion in 1981.

While the omission of this component of economic rent reduces our estimate of total rent, it would have little effect on our estimates of the amount distributed across the nation. This is because in the years for which our estimates were developed the industry was predominantly foreign-owned, and the effective corporate tax rates on the industry were quite low. Thus much of the rent obtained by the industry would have been gained by foreigners, not Canadians.

6 There were three export charge rates in effect in 1980: for light and medium oil and oil condensates; for specified heavy and medium oil, including oil from Wainwright, Alberta; and for Lloydminster crude.

It should be noted that not all shipments of crude oil from the producing provinces to the U.S. market constitute exports. Some of these shipments, referred to as "swaps," are in exchange for oil imported from the United States into Eastern Canada. Thus these swaps are viewed herein as supplying the domestic market and in fact the federal export charge applies only to net exports.

7 The difference between the export charge and the import compensation rate reflects differences in transportation costs between suppliers and markets.

8 The federal export tax on natural gas of 30 cents per thousand cubic feet, introduced on November 1, 1980, did not take effect until February 1, 1981, and thus would not affect the estimates for 1980. Subsequently, under the energy agreements between the federal government and the governments of Alberta and British Columbia, the tax rate on exports of natural gas was set at zero.

9 Glenn P. Jenkins, "Public Utility Finance and Economic Waste," Harvard Institute for International Development, Harvard University, Cambridge, Massachusetts, October 1980 (mimeograph). The "social opportunity cost" of capital is calculated on the basis of the average rate of return from private investment, the rate of time preference for consumption, and the cost of foreign funds to Canada. This social-opportunity-cost rate is estimated to be 10 per cent in real terms. See Glenn P. Jenkins, "Capital in Canada: Its Social and Private Performance, 1965-1974," Economic Council of Canada, Discussion Paper 98, October 1977.

10 Glenn P. Jenkins; Henry Lim; Pierre Poirier; and Richard C. Zuker, "Blue Gold: Hydro-Electric Rent in Canada," Economic Council of Canada, Discussion Paper (forthcoming).

11 The current system is unlikely to be the least costly, even given the hydro resources available, because of factors such as excess capacity, a less-than-optimal mix of different technologies, and a less-than-optimal mix of station sizes. Thus the economic cost of this current system is likely to be too high to be used as an estimate for the least-cost system possible with the hydro resources now available. Therefore, the hydro rent derived as a residual would tend to be on the low side.

12 This appears to be the case in British Columbia.

13 For example, one factor that has an important bearing on the difference in cost between the two systems is the reduction in transmission costs and transmission-line losses that could be realized if distant hydro sites were replaced with thermal plants, which could be located closer to markets. Estimating potential savings with accuracy would require detailed information for each of the provinces.

14 One of the reasons that the estimated rent for British Columbia is comparatively low, given the amount of hydro-electricity produced, is that the close availability of coal reduces the cost of the alternative system.

15 Under the National Energy Program, the federal government offered to share the oil export tax revenues equally with the producing provinces as of November 1980. We have not taken into account in the estimates these potential reductions in the revenue lost by the producing provinces. The provincial share of the export tax revenue for November and December of 1980 is estimated to be in the order of $52 million, with Saskatchewan accounting for about 75 per cent of that.

16 The effect of this tax is that the consumption of synthetic crude has not been subsidized. One producer of synthetic crude did not receive the world price in November and December of 1980, but this has been ignored in the estimates.

17 The estimates of federal revenues from these taxes do not correspond exactly to published figures because, for one thing, the calculations do not reflect the precise manner in which these taxes have been applied in practice.

CHAPTER 5

1 Information provided by the federal Department of Finance suggests that in the most recent year for which data are available (1978), the incremental federal tax that would have been collected had incomes been increased by $1 across Canada was 21 cents. It might be expected that a slightly higher marginal federal tax rate would apply in resource-rich provinces.

2 Water power rentals are fees charged by provincial governments for the right to use the water resources of the province. Most of the revenues derived are from the use of water to produce electricity. Total provincial

government revenues from this source are estimated to have amounted to around $65 million in 1980/81. Conceptually, the estimates of economic rent from the production of hydro-electricity developed in Chapter 4 would include most of the water power rentals received by provincial governments. For this reason, we have assumed that the hydro-electric rents received would be equalized *instead of*, rather than in addition to, water power rentals.

3 According to the principles presented in Chapter 3, what should be equalized are the rents distributed to users within a province, which are not necessarily the same as the rents generated from production in that province. One of the important implications of this approach is that much of the economic rent from Churchill Falls would be included in the equalization formula as fiscal benefits distributed to users in the province of Quebec. The figures utilized for hydro-electricity rents received by consumers are those in the first line of Appendix Table B-7.

4 The one-third cap, or constraint, on the equalization of resource revenues is applied as follows in the current program.

This cap is calculated by considering the sum of total entitlements for seven provinces (the provinces excluding Ontario, Alberta, and British Columbia). The sum of net entitlements resulting from resource revenue categories must not exceed one-third of the sum of the total entitlements for these provinces. (The relevant resource revenue categories are 15 through 23, excluding category 20, and that part of category 29 relating to natural resources.) This is the same as saying that the sum of net entitlements generated by resource revenue categories for these seven provinces must not exceed one-half the sum of the net entitlements of these provinces in *all other* revenue categories.

On the basis of this constraint, or cap, the revenues to be equalized are scaled down proportionately to meet the constraint if and when it is exceeded. Entitlements in these categories are then recalculated. To achieve this scaling-down, the revenues to be equalized in each resource revenue category are multiplied by a ratio. This ratio is one-half the sum of the net entitlements for the seven provinces in categories other than those related to natural resource revenues, divided by the sum of net entitlements resulting from the resource revenue categories for these provinces.

Once the constraint has been applied, total payments to the provinces are determined in the traditional manner. Positive and negative entitlements are totalled for the provinces in all revenue categories. If necessary, the "personal income override" is put into effect.

CHAPTER 6

1 *Report of the Royal Commission on Health Services* [the Hall Commission], vol. 2 (Ottawa: Queen's Printer, 1964), pp. 11-15.

2 The Honourable Emmett M. Hall, *Canada's National-Provincial Health Program for the 1980's: A Commitment for Renewal* (Ottawa: Supply and Services Canada, 1980).

3 Parliamentary Task Force on Federal-Provincial Fiscal Arrangements, *Fiscal Federalism in Canada* (Ottawa: Supply and Services Canada, 1981), p. 122.

4 Quebec, *Report of the Royal Commission of Inquiry on Constitutional Problems*, 4 volumes (Quebec: Queen's Printer, 1956); and the Constitutional Committee of the Quebec Liberal Party, *A New Canadian Federation* (Montreal: Liberal Party of Quebec, 1980).

5 Task Force on Canadian Unity, *A Future Together: Observations and Recommendations* (Ottawa: Supply and Services Canada, 1979), p. 127.

6 The proposed opting-out provision must be distinguished from those which apply to Quebec. In the case of Quebec, the opting-out arrangements are simply a tax abatement, whereby a portion of the federal transfers is "paid" in the form of lower federal tax rates; the total value of the transfers, however, is identical to what it would have been had Quebec not opted out. Also, health insurance conditions apply to Quebec as well.

7 Broad acceptance of EPF was expressed by most provinces in their submissions to the Health Services Review 1979, conducted by the Honourable Emmett Hall, as well as by the federal Ministers of Finance and of Health and Welfare in their submissions to the Parliamentary Task Force on the Federal-Provincial Fiscal Arrangements, 1981. See Hall, *A Commitment for Renewal*; and MacEachen *Fiscal Arrangements in the Eighties*.

8 The Honourable Marc Lalonde [then Minister of Health and Welfare], Speech to the First Ministers' Conference, Ottawa, December 13, 1976, and cited in MacEachen, *Fiscal Arrangements in the Eighties*, p. 80.

9 Tuition fees as a proportion of postsecondary education operating costs at the national level declined from 12.6 per cent in 1974/75 to 10.3 per cent in 1980/81, according to Statistics Canada.

10 As mentioned in Appendix C, however, Newfoundland, Prince Edward Island, and New Brunswick opted for a per capita grant.

11 See MacEachen, *Fiscal Arrangements in the Eighties*.

12 The Revenue Guarantee Program was introduced in 1972 to ensure that provinces adopting the new personal and corporate income tax system would not lose revenue as a result. The program expired at the end of 1976. Its value in 1976/77 was about $900 million. The federal government argued that it had no legal obligation to extend the program. The provinces argued that the federal government had an obligation to do so, since the guarantee had led them to accept the new tax reforms. In negotiations leading up to the 1977 EPF arrangements, a compromise was reached by the addition to the original offer of a per capita cash payment of $7.63 (the national average value of one personal income tax point in 1975/76), adjusted by the EPF fiscal escalator, plus one personal income tax

point (along with the associated equalization) as a tax transfer.

13 Strictly speaking, the fiscal escalator applies only to the basic cash contribution. The value of the transferred tax points, however, is brought up to the value of that basic cash contribution. As a result, to the extent that provinces receive transitional payments, the total value of EPF would grow at the same rate as the basic cash contribution (that is, by the fiscal escalator). Currently, only Alberta and the Yukon Territory do not receive transitional payments.

CHAPTER 7

1 Based on Department of Finance, "Statistical Summary of Federal Contributions to the Provinces and Certain Payments to Institutions and Individuals in the Provinces for the Fiscal Year 1980-81," unpublished data, Ottawa, 1981.

2 The Right Honourable Pierre Elliott Trudeau, "Opening Remarks of the Prime Minister to the Federal-Provincial Conference of First Ministers," Document FP-8-018, Office of the Prime Minister, Ottawa (Press Release, June 14, 1976).

3 Based on "Your Money or Your Life," in *The Economist* (November 1980): 12ff.

4 Based on J. G. Simanis and J. R. Coleman, *Health Care Expenditures in Nine Industrialized Countries, 1960-76*, Social Security Bulletin 43, no. 1 (Washington, D.C.: U.S. GPO, January 1980).

5 This rate of growth in the public funding of health expenditures in Canada exceeds by far the rate of growth in total public expenditures; in the latter category, however, Canada's growth rate was quite low compared with other countries. This development reflects a Canadian policy priority in favour of health services that was distinctly different from that of most other countries during this period.

6 The acronym "CAT" refers to the "computerized axial tomographic" scanner, a sophisticated type of X-ray machine capable of greatly improving diagnostic techniques. According to one estimate, a CAT scanner in Canada costs about $850,000 to buy and $400,000 annually to operate.

7 According to a recent Canadian estimate, 12 per cent (73,440) of premature deaths in Canada in 1974 were found to be attributable to smoking; 6 per cent, to hazardous drinking. Whether premature mortality was expressed in terms of death rate or of potential years of life lost, about 18 per cent of premature mortality in Canada was found to be attributable to smoking and/or drinking. Several studies have indicated that the incidence of various kinds of disease is generally much higher in urban areas than in rural areas, and many of the disparities in morbidity rates have been attributed to air pollution.

8 Based on T. T. Schweitzer, *Personal Consumer Expenditures in Canada, 1926-75, Part 2*, Economic Council of Canada, Staff Study 26 (Ottawa: Queen's Printer, September 1970), pp. 37-38; and a personal communication with T. T. Schweitzer related to estimating equations of services provided by physicians, medical practitioners, dentists, and hospitals.

9 It may also reflect a deepening concern for the welfare of fellow citizens, which might be traced back to the experience of the Great Depression and the favourable development of the postwar years. See, for example, "Public Interest in Individual Health" in the Hall Commission report, vol. I, p. 5.

10 World Health Organization, "Early Detection of Health Impairment in Occupation Exposure to Health Hazards," Technical Report Series No. 571 (Geneva: WHO, 1975).

11 World Bank, *Health* (Washington, D.C.: World Bank, March 1975), pp. 6-7.

12 Estimates of this sort should be interpreted with great caution since they are based on a cross-section of many countries. It is doubtful that health care services around the globe are comparable. Physicians in different countries, for example, do not have the same training; they do not treat the same diseases; and they are not employed in the same areas of specialization. Of the 39,104 physicians in Canada in 1975, for example, only 25,881 were primarily fee-practice physicians. The others, more than one-third, were engaged in research, administration, teaching, or other non-fee-practice activities. Since it is not very likely that this composition is the same in all countries, such international comparisons can, at best, be only approximate. These estimates are based on L. Auer and J. Menic, "Provincial Variations in the Productivity of Physicians in Canada, 1974-76," Economic Council of Canada, Discussion Paper 205, September 1981, pp. 6-7 and Appendix I.

13 Auer and Menic, "Provincial Variations," p. 12 and Appendix III.

14 Statistics Canada, *Hospital Statistics, Volume II – Expenditures, Revenues, Balance Sheets*, 1973, Cat. 83-228, annually, p. 12.

15 Auer and Menic, "Provincial Variations," p. 21.

16 R. G. Evans, "Beyond the Medical Market Place," in *National Health Insurance: Can We Learn from Canada?* ed. S. Andreopoulos (New York: Wiley, 1975), p. 146.

17 Based on W. A. Mennie, "Health Care Costs under Social Security in Canada," a paper prepared for the meeting on the rising costs of medical care under social security, sponsored by the International Labour Organization, May 17-20, 1977, pp. 8-9.

18 Based on Maurice Leclair, "The Canadian Health Care System," in *National Health Insurance: Can We Learn from Canada?* ed. S. Andreopoulos (New York: Wiley, 1975), pp. 74-75.

19 Leclair, "The Canadian Health Care System," p. 77.

20 The Committee on Costs of Health Services, *Task Force Report on Costs of Health Care Services in Canada*, 3 volumes (Ottawa: Queen's Printer, 1970).

21 Leclair, "The Canadian Health Care System," p. 81.

22 The Right Honourable Pierre Elliott Trudeau, "Established Programs Financing: A proposal regarding the

major shared-cost programs in the fields of health and post-secondary education," a statement tabled by the Prime Minister of Canada at the Federal-Provincial Conference of First Ministers, Ottawa, June 14-15, 1976, pp. 1, 4, 6.

EPF was enacted under the *Federal-Provincial Fiscal Arrangements and Established Programs Financing Act*, March 31, 1977, as described in the *Statutes of Canada*, Part III, vol. 1 (Ottawa, 1977), 10, p. 301.

23 *Hospital Insurance and Diagnostic Services Act*, R.S.C. 1970, Chap. H-8, as amended in 1975-77, 10, p. 2.

24 See, for example, Paul C. Weiler, Chairman of the Joint Committee on Physicians' Compensation for Professional Services, *Report* to the Ontario Medical Association, February 20, 1981.

CHAPTER 8

1 See Economic Council of Canada, *Living Together* (Ottawa: Supply and Services Canada, 1977), Recommendations 7, 8, and 9, pp. 223-24.

2 *Report of the Royal Commission on Taxation* [the Carter Commission], vol. 2 (Ottawa: Queen's Printer, 1966), pp. 102-104.

3 Pierre Fortin, "The Comparative Size of the Federal and Provincial Budgets and Economic Stabilization," March 1981; and "Provincial Involvement in Regulating the Business Cycle: Justification, Scope and Terms," April 1981, papers prepared for the Economic Council of Canada.

CHAPTER 9

1 The income from non-incorporated businesses, such as income of the self-employed, and certain other income that is taxed under the personal income tax are allocated across the provinces according to the allocation rules used for corporate income tax.

2 The Rowell-Sirois Commission report.

3 The per capita payments attempted to recognize the fiscal needs of some provinces and the fiscal capacities of the more prosperous provinces. To this end, each agreeing province was usually offered a choice of transfer provisions. For example, in the 1947 Tax Rental Agreements, a province could choose an annual payment of $15 per capita or a payment of $12.75 per capita plus 50 per cent of that province's tax receipts from the fields abandoned in 1940. Under the 1952 agreements, a province could choose per capita payments, as under the former agreements, or a formula offering specified percentages of federal tax yields in the province in the year 1948. In all cases the annual payment was to be subject to an escalation formula related to the growth in incomes and population. An interesting account of the evolution of the agreements is contained in R. M. Burns, *The Acceptable Mean: The Tax Rental Agreements, 1941-1962* (Toronto: Canadian Tax Foundation, 1980).

4 An extended discussion of the allocation rules can be found in E. H. Smith, "Allocating to Provinces the Taxable Income of Corporations: How the Federal-Provincial Allocation Rules Evolved," *Canadian Tax Journal* 24, no. 5 (September-October 1976).

5 The allocation rules in footnote 1 apply here as well.

6 MacEachen, *Fiscal Arrangements in the Eighties*, p. 54.

7 The proposal that appeared in the 1979 British Columbia Budget was designed to encourage investment in high-risk small businesses. As proposed, special deductions would have been available for both individual persons and corporations.

8 The federal government has also disallowed another provincial initiative that would have had the effect of altering the tax base. The Province of Saskatchewan wished to offer preferential treatment of certain capital gains, including those on farms and other small businesses. The preference is currently offered through a rebate directly out of that province's revenue fund.

9 G. F. Break, *Financing Government in a Federal System* (Washington: Brookings, 1980), p. 50.

10 In order to answer this question, it is necessary to determine the influence on labour, capital, and consumers of the national average level of taxes and to reconcile possibly differing provincial preferences on the distribution of the burden among the various factors and consumers.

11 A forceful statement of the position that the desirable degree of fiscal harmonization will come about spontaneously through the action of forces, as here described, is contained in G. Bélanger, "Should Fiscal Harmonization Be Imposed?", a study prepared for the Economic Council of Canada, 1981.

12 See Break, *Financing Government*, p. 62, where he discusses the recent success of the Multistate Tax Commission in uncovering additional business tax revenue through joint audits conducted by the member states.

13 See A. Deutsch and G. Jenkins, "Tax Incentives, Revenue Transfers and the Taxation of Income from Foreign Investment," a paper presented at a Conference on Tax Policy Options in the 1980s, sponsored by the Canadian Tax Foundation (forthcoming in the published proceedings of the Conference).

14 Canadian Tax Foundation, *The National Finances, 1980-81* (Toronto: Canadian Tax Foundation, 1981).

15 This, of course, is controversial. Another suggestion, that of unilateral federal action, has been around for some time. In that case, the federal government would assign a tax liability to provincial Crown enterprises, and the amount of this liability would be deducted from the transfers that would otherwise have been payable to the provinces. Some such scheme was included in the federal budget proposals of 1946 (but there it was part of the Tax Rental Agreements). This provision did not appear in the final 1947 legislation. See Burns, *The Acceptable Mean*.

16 What distinguishes susceptible firms in this regard is the fact that a large proportion of their output is consumed by residents in the province. This is unlike public enterprises created in the resource industries, such as the Saskatchewan Potash Corporation, whose

function is in part to collect rents. In these cases, a large proportion of output is exported outside the province.

17 Similar sorts of problems sometimes arise with private incomes. For example, since it is generally impossible to distinguish between the return to labour and the return to capital in the incomes of non-incorporated enterprises, such as proprietorships and partnerships, the compromise of taxing all income as personal income is used.

Chapter 10

1 Department of Justice, *Consolidation of the British North America Act, 1867 to 1975* (Ottawa: Queen's Printer 1976), pp. 24-28.

2 G. Veilleux, *Les Relations Intergouvernementales au Canada, 1867-1967* (Montréal: Les Presses de l'Université du Québec, 1971), pp. 17-68.

3 D. V. Smiley, *Conditional Grants and Canadian Federalism* (Toronto: Canadian Tax Foundation, 1963), p. 3.

4 Institute of Intergovernmental Relations, *Report: Intergovernmental Liaison on Fiscal and Economic Matters* (Kingston: Queen's University, October 1968), pp. 2I-44.

5 Edgar Gallant, "The Machinery of Federal-Provincial Relations," in *Canadian Public Administration* 7, no. 4 (December 1965):515-16.

6 G. Veilleux, "Intergovernmental Canada: Government by Conference? – A fiscal and economic perspective," in *Canadian Public Administration* 23, no. 1 (Spring 1980):42-43.

7 MacEachen, *Fiscal Arrangements in the Eighties*, Annex VII.

8 D. V. Smiley, "An Outsider's Observations of Federal-Provincial Relations among Consenting Adults," *Confrontation and Collaboration: Intergovernmental Relations in Canada*, ed. R. Simeon (Toronto: Institute of Public Administration of Canada, 1978), pp. 109-10.

9 Burns, *The Acceptable Mean, p. 120.*

10 Richard Simeon, *Federal-Provincial Diplomacy* (Toronto: University of Toronto Press, 1972), p. 136.

11 Richard Simeon, "Federal-Provincial Diplomacy Revisited," an unpublished paper presented to the School of International Studies, John Hopkins University, Washington, D.C., February 27, 1981, p. 1.

12 Smiley, "An Outsider's Observations," pp. 105-106.

13 T. Courchene, "The New Fiscal Arrangements and the Economics of Federalism," *Options: Proceedings of the Future of the Canadian Federation* (Toronto: University of Toronto Press, 1977), p. 345.

14 The Honourable Joe Clark, *Hansard* (Ottawa: Queen's Printer, February 18, 1977), p. 3206.

15 J. S. Dupré, "Reflections on the Fiscal and Economic Aspects of Government by Conference," in *Public Administration in Canada* 23, no. 1 (Spring 1980), pp. 58-59.

16 Veilleux, "Intergovernmental Canada," p. 42.

17 T. d'Aquino, B. Doern, and C. Blair, *Parliamentary Government in Canada*, a study prepared for the Business Council on National Issues (Ottawa: Intercounsel Limited, 1979). This book describes the "executive" processes involved in Canadian parliamentary government.

18 For example, the use of sunset clauses was of particular interest to the last Progressive Conservative federal government.

19 Perhaps the most that analysts can hope for is that all issues will be dealt with and that as many as possible of the groups affected by the fiscal arrangements will actively participate in the review. Albert Breton and Anthony Scott argue that a political market that permits all the relevant actors and interests to participate results in the "best decisions." See Breton and Scott, *The Economic Constitution of Federal States* (Toronto: University of Toronto Press, 1978).

20 Smiley, "An Outsider's Observations," pp. 107-108.

21 R. J. van Loon, "From Shared Cost to Block Funding and Beyond," in *Journal of Health Politics, Policy and Law* (Winter 1978):464-65.

22 H. Ian Macdonald, "Federal-Provincial Issues and Economic Policy-Advising," *Economic Policy Advising in Canada*, ed. David C. Smith (Montreal: C. D. Howe Institute, 1981), p. 258.

23 MacEachen, *Fiscal Arrangements in the Eighties*, pp. 10-11.

24 Alan C. Cairns, "From Interstate to Intrastate Federalism in Canada," Discussion Paper 5, Institute of Intergovernmental Relations, Queen's University, Kingston, 1979, pp. 3-5.

25 This view is often referred to as "federal majoritarianism." See Donald V. Smiley, "The Challenge of Canadian Ambivalence," *Queen's Quarterly* (Kingston: Queen's University, Spring 1981), p. 6.

26 Those advocating this type of reform include the British Columbia government, the Ontario Advisory Committee on Confederation, the Task Force on Canadian Unity (the Pépin/Robarts report), and the Quebec Liberal Party's "A New Canadian Federation," to name but a few.

27 R. Simeon, "The Politics of the Federal-Provincial Fiscal Arrangements," a draft paper prepared for the Economic Council of Canada, Spring 1981.

28 See, for example, A. John Robinson, "An Intergovernmental Commission for Economic Policy," *Fiscal Dimensions of Canadian Federalism*, ed. Richard M. Bird (Toronto: Canadian Tax Foundation, 1980).

29 W. R. Lederman, *The Courts and the Canadian Constitution* (Toronto: McClelland and Stewart, 1964), pp. 200-201.

30 M.J.C. Vile, *The Structure of American Federalism* (Oxford: Oxford University Press, 1961), p. 199.

Chapter 11

1 The Hall Commission report, 2 volumes.

2 This and all other quotations in this chapter are from MacEachen, *Fiscal Arrangements in the Eighties*.

3 Economic Council, *Living Together*.

4 The Carter Commission report, 2 volumes.

Appendix A

1 R. W. Boadway and A. G. Green, "The Economic Implications of Migration to Newfoundland," Economic Council of Canada, Discussion Paper 189, March 1981, pp. I-5 and I-6.

2 This estimate is from Helliwell and Scott, *Canada in Fiscal Conflict*, p. 29.

3 The term "private" here refers to migration factors that are mainly determined by market forces (e.g. wage levels, employment growth, unemployment rates). The term "public" refers to public policies that influence the migration behaviour of each person through their impact on the net fiscal benefits available to people.

4 T. J. Courchene, "Interprovincial Migration and Economic Adjustment," *Canadian Journal of Economics* III, no. 4 (November 1970). Some preliminary work on the role of certain fiscal variables in determining migration to and from Newfoundland was done recently by Boadway and Green in their "Implications of Migration to Newfoundland." M. G. Termote and R. Frechette took into consideration the role of grants provided by the Department of Regional Economic Expansion in explaining interprovincial migration flows; see Termote and Fréchette, *The Variations in the Interprovincial Migration Flow, 1951-1977* (Ottawa: Ministry of State for Urban Affairs, 1979). The effect of unemployment insurance on migration flows between Ontario, Nova Scotia, and New Brunswick was examined by J.-M. Cousineau in "La mobilité interprovinciale de la main-d'œuvre au Canada : le cas de l'Ontario, de la Nouvelle-Écosse et du Nouveau-Brunswick," *L'Actualité Économique*, no. 4 (December 1979). None of these studies, however, provide a systematic evaluation for all provinces of the relationship between major fiscal instruments and interprovincial migration, as found in Courchene.

5 The four income groups include those persons with a total annual income of 1/ less than $10,000 (who pay no income tax); 2/ less than $10,000 (who pay some income tax); 3/ between $10,000 and $20,000; and 4/ over $20,000. The income range for each income group is defined in 1977 constant dollars.

6 These results are drawn from Stanley Winer and Denis Gauthier, "Internal Migration and Fiscal Structure: An Econometric Study of the Determinants of Interprovincial Migration in Canada," a study prepared for the Economic Council of Canada (forthcoming).

7 The word "significant" in this chapter is used in its statistical sense.

8 Since unconditional grants for Ontario, Alberta, and British Columbia are almost nonexistent (equalization payments to these provinces being nil), this result refers to migration from the Atlantic provinces, Quebec, Manitoba, and Saskatchewan to Alberta and British Columbia.

9 For a more detailed discussion of the simulations, see Winer and Gauthier, "Internal Migration."

10 This includes differences in job opportunities and in wage rates.

List of Tables and Charts

Tables

1-1 Federal Transfers to Provincial Governments as a Proportion of Total Gross General Revenue, Canada, Selected Years, 1957-80 1

1-2 Distribution of Federal Expenditures, Excluding Interest Payments, by Type of Expenditure, Canada, 1960-81 7

1-3 Petroleum-Related Federal Revenues and Expenditures, Canada, 1973-80 8

2-1 Change in Provincial-Local Revenue Capacity as a Result of Equalization Payments or Total Federal-Provincial Transfers: The "Gross" Approach, Canada, by Province, 1980/81 18

2-2 Estimates of Net Federal Transfers to Provinces, Canada, 1980/81 19

2-3 Change in Provincial-Local Revenue Capacity as a Result of Equalization Payments or Total Federal-Provincial Transfers: The "Net" Approach, Canada, by Province, 1980/81 20

4-1 Estimates of the Magnitude and Distribution of Natural Resource Rents, Canada, by Province or Territory, 1980 42

5-1 Equalization Entitlements, by Province, and Total Equalization Payments under the Current Program, with Simulations of Alternative Approaches to Equalizing Natural Resource Revenues, Canada, 1980/81 47

5-2 Forecast of Total Equalization Payments: Current Program and Various Alternatives, Canada, 1980/81 to 1986/87 49

5-3 Projected Equalization Entitlements, by Province, and Total Equalization Payments: Current Program and Various Alternatives, Canada, 1982/83 and 1986/87 49

6-1 Major Federal Transfers as Specific-Purpose Grants to Provinces and Territories, Canada, 1980/81 53

6-2 Indexes of Real Provincial Government Total Health Expenditures per Capita, Canada, by Province, 1977/78 to 1980/81 57

6-3 Indexes of Real Provincial Government Postsecondary Education Operating Expenditures per Student, Canada, 1977/78 to 1980/81 57

6-4 Federal Transfers as a Proportion of Provincial Expenditures, Canada, by Province, 1975/76 to 1980/81 59

6-5 Provincial Expenditures and Federal Transfers as a Proportion of Gross National Product, Canada, 1975/76 to 1980/81 60

7-1	Health Care Expenditures as a Proportion of Gross Domestic Product, Selected Countries, 1962 and 1974	64
7-2	Life Expectancy, and Selected Health Resources, Canada, Selected Years, 1931-76	66
7-3	Provincial Variations in Life Expectancy and in Expenditures per Capita on Health Care, Hospitals, and Physicians' Services, Canada, 1976	67
7-4	Provincial Variations in Rated Hospital-Bed Capacity and in Active Civilian Physicians, per Capita, Canada, Selected Years, 1931-75	68
7-5	Operating Costs per Capita, General and Allied Public Hospitals, Canada, 1961-78	69
7-6	Contribution of Labour Requirements, Wage Rates, and Other Operating Expenditures to Annual Changes in Hospital Costs per Patient-Day, Canada, 1961-78	69
7-7	Provincial Variations in Operating Expenditures per Capita, General and Allied Public Hospitals, Canada, 1961-78	70
7-8	Contribution of Patient-Days per Capita and Cost per Patient-Day to Provincial Variations in Operating Expenditures, General and Allied Public Hospitals, Canada, 1961-78	71
7-9	Contribution of the Provincial Age Distribution to Provincial Variations in Patient-Days per Capita, General and Allied Public Hospitals, Canada, 1961-77	71
7-10	Contribution of Labour Hours, Wage Rates, and Other Operating Expenditures to Provincial Variations in Costs per Patient-Day, General and Allied Public Hospitals, Canada, 1961-78	73
7-11	Population per Active Civilian Physician, Canada, by Province, Selected Years, 1961-80	76
7-12	Provincial Variations in the Volume of Physicians' Services per Capita, Canada, Fiscal Years 1974/75 to 1977/78	77
9-1	Degree of Provincial Government Control over Income Taxation under Various Agreements, Canada, 1941-82	91
9-2	Provincial Income Tax Rates, 1981	93
A-1	Quinquennial Net Interprovincial Migration, Canada, by Province, 1951-80	139
B-1	Natural Resource Revenues Collected in Each Province, by Resource Category, Canada, 1980/81	147
B-2	Low Estimate of Rents on Crude Oil, Natural Gas and LPG, and Hydro-electricity, Not Collected by Producing Province, Canada, 1980	148
B-3	High Estimate of Rents on Crude Oil, Natural Gas and LPG, and Hydro-electricity, Not Collected by Producing Province, Canada, 1980	149
B-4	Low and High Estimates of Total and Per Capita Natural Resource Rents, Canada, by Province, 1980	150
B-5	Low and High Estimates of Net Redistribution of Crude Oil Rents to Other Provinces, Canada, 1980	151
B-6	Low and High Estimates of Net Redistribution of Natural Gas and Gas Plant LPG Rents to Other Provinces, Canada, 1980	152
B-7	Estimates of Net Redistribution of Hydro-electricity Rents to Other Provinces, Canada, 1980	153

B-8 Estimates of Net Natural Resource Revenues Redistributed to Other Provinces through Equalization Payments, Canada, 1980/81 154
B-9 Low and High Estimates of Total and Per Capita Net Distribution of Natural Resource Rents, by Province, Canada, 1980 155
D-1 Indexes of Growth in Public and Total Health Expenditures as a Proportion of Gross Domestic Product, Selected Countries, 1962 to 1974 163
D-2 Contribution of Hospital Admission Rates and Length of Hospital Stay to Provincial Variations in Patient-Days per Capita, General and Allied Public Hospitals, Canada, 1961-77 163
D-3 Contribution of Nursing, Diagnostic and Therapeutic Services, Education, and Administrative Support Services to Provincial Variations in Labour Hours per Patient-Day and in Costs per Patient-Day, Canada, 1961-78 164
D-4 Contribution of Nursing, Diagnostic and Therapeutic Services, Education, and Administrative Support Services to Provincial Variations in Wage Rates per Hour and in Costs per Patient-Day, Canada, 1961-78 165
D-5 Contribution of Nursing, Diagnostic and Therapeutic Services, Education, and Administrative Support Services to Provincial Variations in Other Operating Expenditures and in Costs per Patient-Day, Canada, 1961-78 166
D-6 Contribution of Patient-Days per Capita and Cost per Patient-Day to Provincial Variations in Operating Expenditures, General and Allied Public Hospitals, Including and Excluding Mental Institutions, Canada, 1976-78 167
D-7 Provincial Expenditures for Extended Care Facilities per Resident-Day, by Selected Users, Canada, 1977/78 167
D-8 Provincial Expenditures on Physicians' Services per Capita, Canada, Selected Years, 1960-79 168
D-9 Contribution of Specialization to Provincial Variations in Output per Full-Time Physician Equivalent, Canada, 1974-76 168
D-10 Comparison of Physicians' Services with Physicians' Incomes, Canada, by Province, 1974-76 168
D-11 Relative Taxable Incomes of Selected Professionals, Canada, by Province, Selected Years, 1961, 1971, and 1978 169

Charts

1-1 Federal, Provincial, and Local Government Expenditures as a Proportion of Gross National Product, 1950-80 4
2-1 Equalization Payments as a Proportion of Gross National Expenditure, Fiscal Years 1957/58 to 1980/81 15
6-1 Provincial Government Total Health Expenditures per Capita, Canada, 1972/73 to 1980/81 56
6-2 Federal Transfers per Capita, Prior to Established Programs Financing, for Hospital and Medical Insurance, and for Postsecondary Education, Canada, by Province, 1976/77 60

6-3 Net Per Capita Benefit from One Billion Dollars Spent on Equalization Payments or on Equal Per Capita Grants, Canada, by Province, 1980/81 61

7-1 Distribution of Major Expenditures on Personal Health Care, by Type of Expenditure, Canada, 1926/78 65

7-2 Rated Bed Capacity in Mental Institutions, Canada, by Province, 1970 to 1978/79 74

7-3 Relative Taxable Incomes of Selected Professionals, Canada, 1946-78 79

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